

Putting the “Financial Stability” in Financial Stability Oversight Council

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For all the ink that has been spilled on the topic of financial regulation since the financial crisis of 2007–2008, there has been little examination of the competing normative goals of financial regulation. Should the financial system be treated as an end in itself, such that the efficiency of that system is the primary goal? Or should financial regulation instead treat the financial system as a means to the end of broader economic growth? This Article argues for the latter approach, and stakes out the controversial normative position that financial stability, rather than efficiency, should be the paramount focus of financial regulation. Having fixed upon this normative foundation, this Article is in a position to evaluate Dodd–Frank’s creation of the Financial Stability Oversight Council, a body intended to bring the United States’ financial regulators together for the purpose of identifying and responding to threats to financial stability. This Article argues that there are significant flaws in the FSOC’s structure and mandate that will limit its ability to discharge this vital task. Whilst the FSOC is currently the subject of legislative reform proposals, these proposals seek to hobble the FSOC’s powers. This Article argues that reform should instead swing in the other direction. What is needed is an effective and independent regulator with the resources and mandate to take a proactive, long-term, and creative approach to the promotion of financial stability. This Article therefore explores potential reforms to the United States financial regulatory architecture—ranging from the incremental to the more drastic and designed to improve commitment to financial stability.

TABLE OF CONTENTS

I.	INTRODUCTION	1088
II.	THE IMPORTANCE OF FINANCIAL STABILITY REGULATION	1093
	A. <i>The Social Costs of Financial Instability</i>	1093
	B. <i>Financial Stability Regulation</i>	1098
	C. <i>The Inadequacies of a Purely Ex Post-Focused Approach to Financial Stability Regulation</i>	1103

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D. <i>Complexity and Efficiency: Potential Problems with a Proactive Approach to Financial Instability</i>	1107
III. MEET THE FSOC	1113
IV. CONCERNS REGARDING THE FSOC'S STRUCTURE AND MANDATE	1120
A. <i>Problems with the FSOC's Structure</i>	1120
1. <i>Federal Reserve Dominance</i>	1121
2. <i>Treasury Dominance</i>	1126
3. <i>Broader Coordination Challenges</i>	1128
B. <i>Problems with the FSOC's Mandate</i>	1134
V. SOME SUGGESTIONS FOR REFORM	1138
A. <i>A Stand-Alone Prudential Regulator</i>	1138
B. <i>Working Within the Existing Regulatory Framework</i>	1147
VI. CONCLUSION	1152

I. INTRODUCTION

For all the ink that has been spilled on the topic of financial regulation since the financial crisis of 2007–2008 (the Financial Crisis), there are some fundamental matters that have been left largely untouched by the legal scholarship. In particular, the tensions between the competing normative goals that animate financial regulation have gone largely unexplored.¹ This Article wades into these waters, and considers whether financial regulators should focus principally on the efficiency of the financial sector, or instead make financial stability their paramount goal—reflecting a primary concern for the broader economic growth that the financial sector facilitates (and harms). This Article concludes that financial stability should take precedence over efficiency in terms of regulatory goals, and an acceptance of this conclusion begs another undertheorized question: Is the Financial Stability Oversight Council (commonly known as the FSOC), established by the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank) in order “to respond to emerging threats to the stability of the United States financial system,” up to such a critical task?² This Article thus looks in detail at the FSOC’s powers, structure, and mandate, in order to assess its potential to actually mitigate threats to financial stability.

The United States’ financial system is regulated by an alphabet soup of different regulatory agencies,³ and it became apparent during the Financial

¹ For a rare and thoughtful consideration of these normative themes, see generally David A. Westbrook, *Rethinking Financial Markets: A Conference from the WEA Problematique*, WORLD ECON. ASS’N (2012), <http://rfconference2012.weaconferences.net/problematique/> [http://perma.cc/34AG-KFZ2].

² Dodd–Frank Wall Street Reform and Consumer Protection Act § 112(a)(1)(C), 12 U.S.C. § 5322(a)(1)(C) (2012) [hereinafter Dodd–Frank Act].

³ For a list of these agencies, see *infra* note 167 and accompanying text.

Crisis that none of these agencies saw “its job as protecting the economy and financial system as a whole.”⁴ The FSOC was formed in 2010 as one response to this problem⁵: it is a council populated by the heads of the various federal financial regulatory agencies,⁶ and directed to monitor and address threats to financial stability.⁷ The FSOC was not particularly contentious at the time it was first created, but it has become a political hot potato in the past few years, with both the mutual fund and insurance industries seeking to challenge the FSOC’s authority to subject them to heightened regulatory scrutiny.⁸ Prompted by such controversy, several bills have been introduced that propose to restructure the FSOC.⁹ Unfortunately, the aim of such legislative reform is to retrofit the FSOC in a way that creates a bias against proactive financial stability regulation and increasingly politicizes the council.¹⁰ This Article argues that while the FSOC should indeed be restructured, such restructuring should move in the opposite direction and have the goal of making the FSOC a more effective financial stability regulator, particularly by making it less susceptible to the cycle of political economy.¹¹

Public attention to the importance of financial stability tends to be cyclical—waxing during a crisis and waning as the economy starts to recover.¹² As a result, regulators are likely to lack public support for their efforts to promote financial stability unless the system is in crisis mode.¹³ This

⁴THE DEP’T OF THE TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 2 (2009) [hereinafter OBAMA WHITE PAPER], http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf [<http://perma.cc/KUR6-YQDK>].

⁵“The broad membership of the council is intended to limit the tendency of regulators to focus narrowly on the institutions and markets within their jurisdictions while overlooking risks from interdependencies that cut across jurisdictions.” Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Federal Reserve Bank of Chicago 47th Annual Conference on Bank Structure and Competition, Implementing a Macprudential Approach to Supervision and Regulation 5 (May 5, 2011) (transcript available at <http://www.federalreserve.gov/newsevents/speech/Bernanke20110505a.pdf> [<http://perma.cc/QE3W-57Q6>]).

⁶Dodd–Frank Act § 111(b)(1).

⁷§ 112(a).

⁸Specifically, these industries are seeking to challenge the FSOC’s authority to subject non-bank financial institutions to heightened levels of supervision by the Federal Reserve. Floyd Norris, *Financial Crisis, Over and Already Forgotten*, N.Y. TIMES (May 22, 2014), <http://www.nytimes.com/2014/05/23/business/the-financial-crisis-already-forgotten.html> [<http://perma.cc/2DTS-W35R>]. For a discussion of the designation process, see *infra* text accompanying notes 172–75.

⁹See, e.g., S. 107, 114th Cong. (2015); H.R. 4387, 113th Cong. (2014).

¹⁰See *infra* text accompanying notes 272–79.

¹¹See *infra* Part V.

¹²John C. Coffee, Jr., *The Political Economy of Dodd–Frank: Why Financial Reform Tends to Be Frustrated and Systematic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1020–21 (2012).

¹³*Id.*

can make it difficult for regulators to overcome concentrated efforts by the financial industry to avoid and strip away the constraints of financial stability regulation over time. However, the potentially grave consequences of financial instability (and the social costs of *ex post* measures intended to mitigate its fallout) militate against regulators ignoring financial stability issues until a crisis occurs and the public cares about financial stability once more.¹⁴ The FSOC, as the only regulatory body with a statutory direction to address threats to financial stability, should therefore be designed in a way that insulates it as much as possible from this political economy cycle. Unfortunately, both the FSOC's structure and its mandate are flawed in ways that increase the susceptibility of financial stability regulation to the vagaries of political economy.¹⁵

Given the uncertainty inherent in financial stability regulation, it is important that regulators have a solid mandate that legitimizes, and affords them some leeway with regard to, their attempts to preserve financial stability.¹⁶ While the FSOC's mandate does include "identify[ing] risks to the financial stability of the United States" and "respond[ing] to emerging threats to the stability of the United States financial system,"¹⁷ because the term "financial stability" is not defined in Dodd-Frank, the FSOC's mandate is less robust than it could be. Certainly, there is a shared sense that we want to prevent financial institutions from collapsing and causing damage to the broader economy,¹⁸ but this "know-it-when-I-see-it" approach to financial stability provides limited guidance to the FSOC, and this lack of definition opens up the FSOC's actions to challenge by the financial industry (through lobbying, capture, and judicial review).¹⁹

¹⁴ See *infra* Part II.

¹⁵ See *infra* Part IV.

¹⁶ Errors are unavoidable in a system as complex as the financial system, which is characterized by Knightian uncertainty. Nonetheless, financial stability regulation is not doomed to failure. As former Federal Reserve Chairman Ben Bernanke put it:

Our continuing challenge is to make financial crises far less likely and, if they happen, far less costly. The task is complicated by the reality that every financial panic has its own unique features that depend on a particular historical context and the details of the institutional setting. But . . . one can, by stripping away the idiosyncratic aspects of individual crises, hope to reveal the common elements. . . . The challenge for policymakers is to identify and isolate the common factors of crises, thereby allowing us to prevent crises when possible and to respond effectively when not.

Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Fourteenth Jacques Polak Annual Research Conference, The Crisis as a Classical Financial Panic 8 (Nov. 8, 2013) (transcript available at <http://www.federalreserve.gov/newsevents/speech/bernanke20131108a.htm> [<http://perma.cc/YF9S-7AHM>]).

¹⁷ Dodd-Frank Act § 112(a)(1), 12 U.S.C. § 5322(a)(1) (2012).

¹⁸ William A. Allen & Geoffrey Wood, *Defining and Achieving Financial Stability*, 2 J. FIN. STABILITY 152, 152–53 (2006).

¹⁹ See *infra* text accompanying notes 295–302.

The key structural concern regarding the FSOC is that while it has been given an express mandate to pursue financial stability, the agencies led by its members have not: because the FSOC is a council rather than a body with substantial staff of its own, if the financial regulatory agencies represented on the FSOC are not concerned with financial stability issues, then a council of those agencies is unlikely to be effective in pursuing financial stability.²⁰ This Article concludes that, at present, these other federal financial regulatory agencies (with the possible exception of the Federal Reserve) have only nebulous responsibility for financial stability concerns, and this responsibility is easily shirked when the economy is booming and regulatory intervention has become unpalatable.²¹ Unless there is a way to focus and maintain the attention of these agencies on financial stability, the FSOC will be unable to leverage their expertise, and its efficacy will be limited.

Although the Federal Reserve (which is one of the agencies represented on the FSOC)²² has shown an inclination to fill the breach and take de facto responsibility for financial stability issues, this is not a uniformly positive development. The Federal Reserve has a tendency to prefer bank-centric approaches to regulation,²³ notwithstanding that the promotion of financial stability requires a broad imagination about the types of shocks and transmission mechanisms that can generate crises.²⁴ To be truly effective in addressing threats to financial stability, the FSOC should benefit from the different types of expertise of *all* of the federal financial regulatory agencies: the Federal Reserve should not be dominant to the exclusion of all other agencies. The dominance of the Treasury Secretary within the FSOC is cause for concern for different reasons; as a Presidential appointee, the Treasury Secretary has less independence from the political process than the other FSOC members.²⁵ The prominence of the Treasury Secretary thus has the potential to render the FSOC even more susceptible to the political economy of the financial regulatory cycle than it would otherwise be.²⁶

²⁰ See *infra* Part IV.A.3.

²¹ See *infra* Part IV.A.3.

²² Dodd–Frank Act § 111(b)(1)(B).

²³ See *infra* notes 209–12 and accompanying text.

²⁴ In a letter to the Queen of England addressing her question “why had nobody noticed that the credit crunch was on its way?”, the British Academy for the Humanities and Social Sciences responded:

[T]he failure to foresee the timing, extent and severity of the crisis and to head it off, while it had many causes, was principally a failure of the collective imagination of many bright people, both in this country and internationally, to understand the risks to the system as a whole.

Letter from Tim Besley, Professor, London Sch. of Econ., and Peter Hennessey, Professor, Queen Mary Univ. of London, to Her Majesty The Queen 3 (July 22, 2009), <http://www.britac.ac.uk/events/archive/forum-economy.cfm> [<http://perma.cc/4JKZ-9YGA>].

²⁵ See *infra* Part IV.A.2.

²⁶ See *infra* Part IV.A.2.

This Article suggests a number of reforms intended to address the concerns raised about the FSOC's structure and mandate. One far-reaching, and potentially very effective, reform would be to consolidate prudential supervision of *all* United States financial institutions into a single well-resourced prudential regulatory agency, and then abolish the FSOC. Australia's successful experience with its Australian Prudential Regulatory Authority could serve as a template for designing such an agency.²⁷ Recognizing, however, the intransigence of the United States' federal financial regulatory architecture, this Article also explores a number of reforms intended to work largely within the existing regulatory structure. These range from requiring financial stability-related testimony and certifications from the heads of each federal financial regulatory agency, to amending Dodd–Frank to include a definition of “financial stability,” to implementing a statutory financial stability mandate for all of the federal financial agencies. Such a mandate would be designed to mitigate the political economy of the financial regulatory cycle by training regulatory attention on financial stability issues even in normal and boom times, when the public is largely oblivious to such issues. The mandate would also assist in fostering a regulatory identity that is more impervious to capture, and permit regulators to develop broader, simpler, rules that are better calculated to promote stability than rules that deal too granularly with the minutiae of financial activities.²⁸

The remainder of the Article proceeds as follows. Part II discusses why financial stability regulation is so important, and makes the case for proactive financial stability regulation, rather than simply letting instability develop and then cleaning up after the fact. In particular, Part II tackles the normative question of how we should balance the need for financial stability with the desire for an efficient financial system. Part III provides an introduction to the FSOC that provides context for the remainder of the Article. Part IV discusses some of the operational difficulties the FSOC faces in pursuing its financial stability mandate, highlighting the problems of member agency coordination as well as the problematic dominance of the Federal Reserve and the Treasury. It then moves on to consider the inconsistencies, ambiguities, and general lack of clarity inherent in the mandate itself, particularly when it comes to the threshold issue of what exactly we mean by “financial stability.” Part V responds to the concerns raised in Part IV by suggesting some reform options, the most meaningful and radical of which involves the creation of a stand-alone prudential regulator with resources that befit the gravity of the task of regulating for financial stability. Part VI concludes.

²⁷ See *infra* notes 320–25 and accompanying text.

²⁸ See *infra* Part V.B.

II. THE IMPORTANCE OF FINANCIAL STABILITY REGULATION

A. *The Social Costs of Financial Instability*

When the financial system breaks down, there is usually a negative impact on the price of financial assets: highly-leveraged financial institutions will likely need to sell their assets quickly, which can depress asset prices system-wide,²⁹ and this can precipitate a lack of confidence that leads other investors to seek an “early-mover advantage” by selling off their financial assets before other investors do (in popular parlance, a “run”).³⁰ The financial system is the primary provider of credit to the broader economy, and in this type of environment, financial institutions tend to restrict lending.³¹ From a macroeconomic perspective, this is how the real harm occurs. When businesses and local governments are no longer able to obtain credit through the incapacitated financial system, it limits their ability to expand and prevents broader economic growth.³² This Article argues that the most pernicious aspect of the Financial Crisis was not the harm that it inflicted on financial assets and institutions, but the longer term slowdown of macroeconomic growth that ensued.³³

The negative macroeconomic effects of the Financial Crisis have proved more enduring than the hit to financial asset prices. Stock prices returned to

²⁹ Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007–2008*, 23 J. ECON. PERSP. 77, 94 (2009).

³⁰ *Id.* at 96.

³¹ Hilary J. Allen, *A New Philosophy for Financial Stability Regulation*, 45 LOY. U. CHI. L.J. 173, 183 (2013).

³² Brunnermeier, *supra* note 29, at 90.

³³ In many respects, this concern is similar to the concerns expressed by Piketty in his book *Capital in the Twenty-First Century*. To grossly oversimplify, Piketty’s thesis is that the rate of return on capital (“r”—where capital is comprised of financial and non-financial assets) is likely to exceed the rate of economic growth (“g”) in the twenty-first century. THOMAS PIKETTY, *CAPITAL IN THE TWENTY-FIRST CENTURY* 25–26 (Arthur Goldhammer trans., 2014). Those without significant amounts of accumulated capital derive income primarily from wages that remain stagnant or even shrink as economic growth slows, and thus wealth is concentrated in the hands of a very small group that has already amassed significant amounts of capital that is appreciating at a rate of return in excess of what most people can earn as wages. *See id.* Piketty’s chief recommendation to address this dynamic of widening inequality is the implementation of progressive taxes on capital. *Id.* at 471. This Article does not purport to comment on the merits of such proposal, nor does it engage with Piketty’s thesis about declining growth rates more generally. Instead, it notes that one of the key problems identified by Piketty—that inequality becomes further entrenched when $r > g$ —is worsened by financial crises that exacerbate the disparity between r and g by suppressing broad-based economic growth. *Id.* So long as $r > g$, “past wealth naturally takes on disproportionate importance, because it takes only a small flow of new savings to increase the stock of wealth steadily and substantially.” *Id.* at 25.

their pre-Crisis heights by March of 2012,³⁴ but the picture with regard to employment remained far less sanguine for far longer—and the majority of the population is much more dependent on wages for their livelihood than on financial assets.³⁵ The unemployment rate in the United States peaked at 10% in October of 2009 (with underemployment at that time estimated at 17.4%),³⁶ and although unemployment has been steadily declining since then, when the stock market recovered to pre-Crisis levels in March of 2012, the unemployment rate was still 8.2%.³⁷ Even as of May 2015, the unemployment rate was 5.5%—still much higher than the 4.6% rate that pertained in June of 2007.³⁸ Furthermore, unemployment has remained particularly high among African-Americans and Hispanics, as well as amongst young Americans³⁹—leading to fears of a “lost generation” that may never develop the skills and experience necessary to establish long-term employment.⁴⁰ Even for those who are employed, wages (other than for superstars and CEOs)⁴¹ have remained largely stagnant—not just since the Financial Crisis, but since the bursting of the dot-com bubble in 2001.⁴² It is not surprising, then, that the

³⁴ Christine Hauser, *NASDAQ Finishes Above 3,000, Its Best Since Dot-Com Bubble*, N.Y. TIMES (Mar. 13, 2012), http://www.nytimes.com/2012/03/14/business/stocks-rally-to-pre-2008-heights.html?_r=0 [http://perma.cc/PJ4A-88S3].

³⁵ According to Gallup’s annual Economics and Personal Finance survey, in April of 2013 only 52% of all American adults had *any* investments in the stock market (down from a pre-Crisis high of 65%). See Lydia Saad, *U.S. Stock Ownership Stays at Record Low*, GALLUP (May 8, 2013), <http://www.gallup.com/poll/162353/stock-ownership-stays-record-low.aspx> [http://perma.cc/SBG2-PST3].

³⁶ See generally FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 390 (Jan. 2011). This underemployment rate includes part-time workers who would prefer to be fully employed and those who are too discouraged to look for work, in addition to those who are unemployed and actively searching for work.

³⁷ All statistics relating to unemployment levels are drawn from the Bureau of Labor and Statistics. U.S. Dep’t of Labor, *Databases, Tables & Calculators by Subject*, BUREAU OF LAB. STAT., <http://data.bls.gov/timeseries/LNS14000000> [http://perma.cc/XM8T-66KB].

³⁸ *Id.*

³⁹ David M. Schizer, *Fiscal Policy in an Era of Austerity*, 35 HARV. J.L. & PUB. POL’Y 453, 456 (2012).

⁴⁰ Robert J. Samuelson, *Is the Economy Creating a Lost Generation?*, WASH. POST (Dec. 9, 2012), https://www.washingtonpost.com/opinions/robert-samuelson-is-the-economy-creating-a-lost-generation/2012/12/09/41683956-4093-11e2-bca3-aadc9b7e29c5_story.html [http://perma.cc/2EXY-2WDC].

⁴¹ Krugman notes that wage income for the very top earners in America has surged. Paul Krugman, *Why We’re in a New Gilded Age*, N.Y. REV. BOOKS (May 8, 2014), <http://www.nybooks.com/articles/archives/2014/may/08/thomas-piketty-new-gilded-age/> [http://perma.cc/F82N-KE3N].

⁴² LAWRENCE MISHLE ET AL., THE STATE OF WORKING AMERICA 5–6 (12th ed. 2012).

Pew Research Center has found that:

[U]pper-income families have begun to regain some of the wealth they lost during the Great Recession, while middle-income families haven't seen any gains. The median wealth among upper-income families increased from \$595,300 in 2010 to \$639,400 in 2013 (all dollar amounts in 2013 dollars). The typical wealth of middle-income families was basically unchanged in 2013—it remained at about \$96,500 over the same period.⁴³

It is important to note that not all of the consequences of the Financial Crisis can be measured in percentages or dollar terms. Federal Reserve Chair Janet Yellen has stressed that, when discussing unemployment, “[t]hese are not just statistics. . . . The toll is simply terrible on the mental and physical health of workers, on their marriages, on their children.”⁴⁴ Ronald A. Wilson, the presiding judge of the municipal court of South Tucson, Arizona in 2009, wrote a particularly poignant account of the impact of the Financial Crisis on society's most vulnerable:

[M]y position as presiding judge . . . provides me with ample opportunity to observe the effects of the current economic crisis on indigent defendants who appear before me. These people include single parents living with their small children in cars, under bridges, in alleys, and in the desert; unemployed people who have lost their homes; and homeless veterans suffering from mental illness and co-occurring substance abuse problems. The worsening economic conditions have significantly impacted this population. I have seen an increase in petty misdemeanors and quality-of-life crimes. . . .

. . . .

. . . My shoplifters steal food, toilet paper, deodorant, diapers, aspirin, bug spray, bandages, batteries, flashlights, blankets, soap, and beer. . . .

. . . Loitering, panhandling, criminal trespass, and failure to obey lawful order citations have also increased. . . .

. . . .

⁴³ In its analysis, the Pew Research Center refers to wealth as “the difference between the value of a family's assets (such as financial assets as well as home, car and businesses) and debts.” Richard Fry & Rakesh Kochhar, *America's Wealth Gap Between Middle-Income and Upper-Income Families Is Widest on Record*, PEW RES. CTR. (Dec. 17, 2014), <http://www.pewresearch.org/fact-tank/2014/12/17/wealth-gap-upper-middle-income/> [<http://perma.cc/C7C2-NWC3>].

⁴⁴ Janet L. Yellen, Vice Chair, Bd. of Governors of the Fed. Reserve Sys., Remarks at “A Trans-Atlantic Agenda for Shared Prosperity”: A Conference Sponsored by the AFL-CIO, Friedrich Ebert Stiftung, and the IMK Macroeconomic Policy Institute, A Painfully Slow Recovery for America's Workers: Causes, Implications, and the Federal Reserve's Response 10 (Feb. 11, 2013) (transcript available at <http://www.federalreserve.gov/news-events/speech/yellen20130211a.pdf> [<http://perma.cc/68BV-527M>]) (footnote omitted).

Crimes related to substance abuse are also on the rise. As people lose their jobs, their homes, and their livelihood, they often slip into depression. Without health care, they often self-medicate with alcohol or other drugs in order to cope with their feelings of failure, abandonment, loss, anger, confusion, and betrayal. Too often the drugs and alcohol lead to driving under the influence, domestic violence, possession of narcotic paraphernalia, drinking in public, or disorderly conduct.

In addition to quality-of-life crimes, there are also several criminal traffic and civil traffic offenses that are on the rise. Within a few weeks of unemployment, many people fail to renew their car insurance or registration. . . . What they fail to realize is that driving without a valid registration or car insurance may result in significant fines and the suspension of their driver's license. . . . If they are caught driving on a suspended license, the vehicle that they are driving will be impounded and the driver will be taken to jail. Often this is the only vehicle in the household. . . .

When a person lives in an area that has poor public transportation, . . . no license and no car means no job. In addition, people in these areas will now find it very difficult to get their children to day care, doctor's appointments, or school.⁴⁵

Research has also found deleterious consequences of the Financial Crisis in matters as diverse as pro se litigation⁴⁶ and reproduction rates,⁴⁷ and the

⁴⁵ Ronald A. Wilson, *The View from South Tucson: How the Economic Crisis Affects Defendants in My Courtroom*, 48 JUDGES' J. 14, 14, 34 (2009).

⁴⁶ Richard W. Painter, *Pro Se Litigation in Times of Financial Hardship—A Legal Crisis and Its Solutions*, 45 FAM. L.Q. 45 (2011).

⁴⁷ Ross Douhat has noted:

American fertility plunged with the stock market in 2008, and it hasn't recovered. Last week, the Pew Research Center reported that U.S. birthrates hit the lowest rate ever recorded in 2011, with just 63 births per 1,000 women of childbearing age. (The rate was 71 per 1,000 in 1990.) . . .

. . . American fertility plummeted during the Great Depression, and more recent downturns have produced modest dips as well.

Ross Douhat, *More Babies Please*, N.Y. TIMES (Dec. 1, 2012), http://www.nytimes.com/2012/12/02/opinion/sunday/douhat-the-birthrate-and-americas-future.html?_r=0 [<http://perma.cc/7LZ2-GSJ3>].

A study from the Max Planck Institute for Demographic Research found that a period of stable to rising fertility rates across Europe came to a halt, and in some countries reversed, after 2008.

medical literature highlights some of the dangers that financial instability can pose for health. For example, a Duke study considered the “potential relation between U.S. stock market volatility and cardiovascular events” by looking at whether there was a significant increase in the occurrence of heart attacks during and immediately after the Financial Crisis.⁴⁸ Particularly when looking at the period from October 2008 to April 2009, the study found a statistically significant increase in the number of acute myocardial infarctions.⁴⁹ Also disturbing is a study that appeared in *The Lancet* regarding the suicide rate in the United States following the Financial Crisis, which found that there were an additional 1,580 suicide deaths per year in the years 2008–2010, when compared to the suicide mortality rate in the years 1999–2007.⁵⁰ With regard to health more generally, one study concluded that because of financial constraints, people suffering from medical problems were less likely to seek medical assistance in the wake of the Financial Crisis.⁵¹

This Part’s survey of social costs is by necessity abbreviated, but even this brief discussion makes clear that while the United States’ economy may now be rebounding, some of the damage inflicted by the Financial Crisis cannot be undone. Furthermore, to the extent that recovery is possible, it has not been consistent—the bulk of the ongoing social costs of the Financial Crisis are being borne by the more economically vulnerable members of society.⁵² Even a limited survey of the outcomes of the Financial Crisis thus makes a very strong case for treating financial stability not just as “nice to have,” but something that should be proactively pursued by financial regulators.

The reversal was particularly acute in Spain, Hungary, Ireland, Croatia, and Latvia, the study found. With the exception of Ireland, low fertility in each threatened the ability of future governments to support growing numbers of the elderly, who rely on the next generation of taxpayers to provide their pensions.

Norma Cohen, *Financial Hardship Drives Europe’s Fertility Rate Down*, FIN. TIMES (July 11, 2013), <http://www.ft.com/cms/s/0/1b0fc39e-e982-11e2-bf03-00144feabdc0.html#axzz3jHUfbnXN> [http://perma.cc/6B3T-HGEH].

⁴⁸ Mona Fiuzat et al., *United States Stock Market Performance and Acute Myocardial Infarction Rates in 2008–2009 (from the Duke Databank for Cardiovascular Disease)*, 106 AM. J. CARDIOLOGY 1545, 1547 (2010).

⁴⁹ *Id.*

⁵⁰ Aaron Reeves et al., *Increase in State Suicide Rates in the USA During Economic Recession*, 380 LANCET 1813, 1813 (2012).

⁵¹ Annamaria Lusardi et al., *The Economic Crisis and Medical Care Use: Comparative Evidence from Five High-Income Countries*, 96 SOC. SCI. Q. 202, 203 (2015).

⁵² Fry & Kochhar, *supra* note 43; see also ALDO CALIARI, CTR. OF CONCERN, INEQUALITY AND FINANCIAL REGULATION: PART AND PARCEL OF A POST-2015 DEVELOPMENT AGENDA? (Oct. 2012), <https://www.worldwewant2015.org/file/284057/download/307928> [https://perma.cc/6P7G-EJQK].

B. Financial Stability Regulation

In previous work, I have lamented the lack of attention paid to what is meant by the term “financial stability”: without a clearly defined goal, financial stability regulation lacks legitimacy, and is likely to be implemented inconsistently.⁵³ In order to clarify the meaning of the term, I have argued that “financial stability” should be defined to reflect both technical notions about the state of the financial system during periods of stability, and a value-based assessment about the importance of the financial system as a means to broader economic prosperity.⁵⁴ With regard to the former, the definition of financial stability should emphasize that the mere absence of crisis does not denote stability. A stable financial system is also able to “absorb (rather than amplify) shocks”—no matter where they may arise (meaning that the focus of financial stability regulation should be broader than just “too big to fail” financial institutions).⁵⁵ With regard to the social policy dimensions of financial stability, if financial institutions and markets could fail without harming the broader economy, then financial stability would not be such an important public policy goal. Unfortunately, the externalities of such failures (particularly the freezing up of credit) cause indirect harm to broad swathes of the economy, and so financial stability should be defined as a public good, something that must be nurtured even in good times when the financial system does not appear to need any government intervention.⁵⁶

The aim of financial stability regulation should be to prevent the externalization of the consequences of risks taken within the financial system to people who are outside of the financial system (and who have not agreed to bear such risks).⁵⁷ Historically, financial stability regulation has not had such a

⁵³ Hilary J. Allen, *What Is “Financial Stability”? The Need for Some Common Language in International Financial Regulation*, 45 GEO. J. INT’L L. 929, 935 (2014). For a working definition of “financial stability,” see *infra* Part V.B.

⁵⁴ In a similar vein, Rahman argues that financial reform should be informed by both moral and technical reasoning:

The problem of financial reform is not merely one of technical policy design; it is also a thickly *moral* problem that involves weighty judgments about what a good economy looks like, what kinds of financial transactions are socially valuable, and about how we ought to distinguish, balance, and regulate these different kinds of activities.

K. Sabeel Rahman, *Managerialism, Structuralism, and Moral Judgment: Law, Reform Discourse, and the Pathologies of Financial Reform in Historical Perspective* 4 (Nov. 2013) (prepared for presentation at the Joint Program of the Financial Institutions and European Law Sections, AALS Annual Meeting, New York City, January 3, 2014, for the panel “Taking Stock of Post-Crisis Reforms: Local, Global, and Comparative Perspectives on Financial Sector Regulation”), <http://ssrn.com/abstract=2368292> [<http://perma.cc/8PHM-WXJT>].

⁵⁵ Allen, *supra* note 53, at 943–44.

⁵⁶ *Id.* at 946–47.

⁵⁷ Allen, *supra* note 31, at 182.

sweeping purview. Prior to the Financial Crisis, financial stability regulation was decidedly microprudential in orientation in the sense that regulatory attention was trained on individual financial institutions (primarily banks), rather than on the system as a whole.⁵⁸ It was assumed that so long as individual banks had sufficient buffers of loss-absorbing capital and were prudently managed (in the regulatory lingo, were “safe and sound”), then the financial system as a whole would be safe.⁵⁹ However, the Financial Crisis shattered that assumption: in 2008, financial institutions (including non-banks) started to sell off assets in fire sales in an attempt to protect their own safety and soundness, but such fire sales depressed asset values and damaged confidence system-wide, harming the ability of other institutions and markets to function.⁶⁰ The Financial Crisis thus illustrated that an institution’s attempts to preserve its safety and soundness may come at the expense of the stability of the financial system as a whole, and post-Crisis, regulators have come to embrace the need to look beyond individual financial institutions and take a more “macroprudential” approach to financial regulation.⁶¹

A macroprudential approach dictates that financial stability regulation should not restrict its focus to the safety and soundness of the system’s key component parts: financial regulators must also pay close attention to the interactions and linkages between the financial institutions and markets that constitute the financial system.⁶² Since the Financial Crisis, proposals have been made for new types of financial stability regulation that reflect this systemic perspective, including a pre-approval process for new financial products,⁶³ limitations on the size of financial institutions,⁶⁴ and transaction taxes.⁶⁵ At present, however, there is little political will to pursue such measures. Instead, Dodd–Frank tends to mandate the use of more traditional regulatory tools to promote financial stability, like activities restrictions (such as the Volcker Rule),⁶⁶ leverage and capital requirements,⁶⁷ and clearing and

⁵⁸ Samuel G. Hanson et al., *A Macroprudential Approach to Financial Regulation*, 25 J. ECON. PERSP. 3, 3 (2011).

⁵⁹ *Id.* at 4–5.

⁶⁰ *See id.* at 5.

⁶¹ Bernanke, *supra* note 5, at 12.

⁶² Hanson et al., *supra* note 58, at 3.

⁶³ Saule T. Omarova, *License to Deal: Mandatory Approval of Complex Financial Products*, 90 WASH. U. L. REV. 63, 66 (2012); Eric A. Posner & E. Glen Weyl, *An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to Twenty-First-Century Financial Markets*, 107 NW. U. L. REV. 1307, 1309–10 (2013).

⁶⁴ SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 214–17 (2010).

⁶⁵ For a discussion of Pigouvian taxes in the financial sector, see Douglas A. Shackelford et al., *Taxation and the Financial Sector*, 63 NAT’L TAX J. 781 (2010).

⁶⁶ Dodd–Frank Act § 619, 12 U.S.C. § 1851 (2012).

⁶⁷ *Id.* § 171.

disclosure requirements.⁶⁸ However, these traditional tools are being approached for the first time from a macroprudential, as well as microprudential, perspective. For example, leverage and capital requirements are by no means new tools, but now regulators are considering deploying them in a countercyclical way (i.e., using them to tamp down an incipient boom, and to loosen restrictions in a slump).⁶⁹ Constant monitoring of the entire financial system, and the risks building up within it, is an essential precondition to knowing when and how to deploy these traditional regulatory tools to macroprudential ends—and indeed a precondition to financial stability regulation more generally.⁷⁰

While financial stability regulation is an important undertaking, it is also a difficult one, facing numerous challenges. The global nature of financial institutions and markets dictates that financial stability regulation must be an international endeavor, yet global agreement on financial stability regulation can be hard to come by.⁷¹ At both the international and the domestic level, financial institutions tend to arbitrage financial stability regulation in a way that can thwart its efficacy.⁷² In addition, the complexity of the interconnected actors and products that constitute the financial system can complicate

⁶⁸ See, for example, *id.* tit. 7, as it applies to clearing and disclosure requirements for swaps.

⁶⁹ For example “the regulator can lower leverage and/or credit-extension ceilings, and/or boost reserve and/or capital buffer requirements, and/or raise liquidity minima and/or lower maturity mismatch maxima during boom phases, while doing the contrary during slump phases.” Robert Hockett, *The Macroprudential Turn: From Institutional ‘Safety and Soundness’ to Systemic ‘Financial Stability’ in Financial Supervision*, 9 VA. L. & BUS. REV. 201, 225 (2015). Although there is a broad literature on the difficulties inherent in diagnosing asset booms and bubbles, Gerding argues persuasively that we need not fixate on figuring out precisely when asset values have diverged from fundamentals. Instead, he suggests that policy be guided by:

[E]conomic research [that] does point to a list of warning signs that booming prices in asset markets may be unsustainable. These early warning alarms include more than skyrocketing asset prices and ratios of prices to earnings. They also include the following:

- historically cheap credit (measured by, among other things, low interest rates and a growing money supply);
- higher leverage of households, financial institutions, and governments;
- a surge of external capital flowing into a country (measured by trade or current account balances); and
- an influx of inexperienced investors into a market.

ERIK F. GERDING, LAW, BUBBLES, AND FINANCIAL REGULATION 47 (Nicholas Mercuro & Michael D. Kaplowitz eds., 2014) (footnotes omitted).

⁷⁰ Robert C. Hockett, Implementing Macroprudential Finance-Oversight Policy: Legal Considerations 14 (Oct. 14, 2013) (unpublished manuscript), <http://ssrn.com/abstract=2340316> [<http://perma.cc/ZB4U-B53X>].

⁷¹ Allen, *supra* note 53, at 929–31.

⁷² Iman Anabtawi & Steven L. Schwarcz, *Regulating Ex Post: How Law Can Address the Inevitability of Financial Failure*, 92 TEX. L. REV. 75, 100–01 (2013).

financial stability regulation,⁷³ and political economy concerns can undermine financial stability regulation.⁷⁴ These last two concerns are particularly salient when considering how best to design financial regulatory architecture (the focus of Parts IV and V of this Article), and so they are worthy of some further elaboration here.

First, the complexity of the constantly evolving financial system ensures that threats to financial stability do not always come from expected sources.⁷⁵ As such, regulators can never be overconfident about which parts of the system may generate financial instability.⁷⁶ Caution against such overconfidence is an important lesson from the Financial Crisis: before the Financial Crisis, many believed that commercial banks were the only institutions subject to maturity mismatch (meaning they used short-term funding to acquire longer term assets), and therefore that commercial banks were the only institutions that were vulnerable to the runs and panics that could precipitate financial crises.⁷⁷ However, runs in the money market mutual fund and repo markets during the Financial Crisis illustrated that susceptibility to runs was not unique to commercial banks.⁷⁸ Furthermore, events like the “Flash Crash” that have occurred since the Financial Crisis suggest that future instability might be generated by financial institution activities that have nothing to do with maturity mismatch.⁷⁹ As such, financial stability regulators must keep an open mind and an expansive view of the interconnections within the financial system.⁸⁰

Turning to the political economy of financial stability regulation, recent experience suggests that once a financial crisis develops, there will be

⁷³ Allen, *supra* note 31, at 189–90.

⁷⁴ For a fulsome discussion of the political economy of Dodd–Frank, see generally Coffee, *supra* note 12.

⁷⁵ Financial stability regulation is particularly concerned with “what happens in lower-probability, higher-impact crisis circumstances (known as ‘fat-tail’ events), when rational assumptions about the operation of [the financial system] are less likely to hold.” Allen, *supra* note 31, at 193 (footnote omitted).

⁷⁶ See Daniel Schwarcz & Steven L. Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. CHI. L. REV. 1569, 1574 (2014) (regarding the dangers of dismissing “alternative potential sources of systemic risk because of the perceived lack of historical precedents”).

⁷⁷ RICHARD SCOTT CARNELL ET AL., *THE LAW OF FINANCIAL INSTITUTIONS* 57 (5th ed. 2013).

⁷⁸ Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, 2010 BROOKINGS PAPERS ON ECON. ACTIVITY 261, 267 (2010).

⁷⁹ See *infra* text accompanying notes 226–28.

⁸⁰ “[O]wing to the changing nature of the financial system, banks could no longer be considered the unique source of systemic risk.” Michael W. Taylor, *The Road From “Twin Peaks”—and the Way Back*, 16 CONN. INS. L.J. 61, 85 (2009). Instead, regulators should be looking for structural interconnections and vulnerabilities throughout the financial system. Schwarcz & Schwarcz, *supra* note 76, at 1575.

sufficient political will to address it.⁸¹ However, when the financial system appears to be performing well, the public and politicians tend to have little appetite for financial stability regulation⁸² (to the extent that the public is paying any attention at all to financial stability regulation during normal times, such regulation is liable to be interpreted as an encroachment on private freedoms).⁸³ The financial industry will be paying keen attention to financial stability regulation at all times, however, and has consistently strong (and reasonably uniform) incentives to lobby financial regulatory agencies to diminish financial stability regulations that impose short-term costs on the industry.⁸⁴ Such lobbying efforts can be difficult for regulators to resist in the absence of public support.

The influence of the financial industry in times of societal apathy can also be exerted in ways that are much less overt than lobbying. Cognitive capture is a phenomenon that has been much discussed in the financial regulatory sphere.⁸⁵ This type of capture doesn't necessarily evince any venal corruption of regulatory agencies—instead, merely by identifying with the financial industry (perhaps because they share social networks, or because they admire the industry's expertise), financial regulators sometimes take on the worldview of that industry.⁸⁶ The risk of regulators doing so becomes particularly acute at times when the public has no interest in financial regulatory matters.⁸⁷ Cognitive capture can also arise when the regulator is dependent on the financial industry for its information: that information is often filtered through the industry's perspective before the regulator even receives it.⁸⁸ When cognitive capture is at work, financial regulators tend to view the "public interest" as being synonymous with the efficiency and short-term profitability of the financial industry they regulate.⁸⁹ However, this type of regulatory

⁸¹ Anabtawi & Schwarcz, *supra* note 72, at 96. *See generally* Andrew Crockett, *Why Is Financial Stability a Goal of Public Policy?*, in MAINTAINING FINANCIAL STABILITY IN A GLOBAL ECONOMY: A SYMPOSIUM SPONSORED BY THE FEDERAL RESERVE BANK OF KANSAS CITY 7, 27 (1997); Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L. J. 435, 439 (2011).

⁸² Anabtawi & Schwarcz, *supra* note 72, at 96–98. Coffee notes that there is no natural constituency for financial stability regulation that can counterbalance the political power of financial institutions. Coffee, *supra* note 12, at 1031–32.

⁸³ Jodi L. Short, *The Paranoid Style in Regulatory Reform*, 63 HASTINGS L.J. 633, 671 (2012).

⁸⁴ Coffee, *supra* note 12, at 1027.

⁸⁵ *See, e.g.*, James Kwak, *Cultural Capture and the Financial Crisis*, in PREVENTING REGULATORY CAPTURE: SPECIAL INTEREST INFLUENCE AND HOW TO LIMIT IT 71 (Daniel Carpenter & David Moss eds., 2013).

⁸⁶ *Id.* at 77.

⁸⁷ John C. Coffee, Jr., *Systemic Risk After Dodd–Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 815 (2011).

⁸⁸ Allen, *supra* note 31, at 199.

⁸⁹ Willem H. Buiter, *Central Banks and Financial Crises*, in MAINTAINING STABILITY IN A CHANGING FINANCIAL SYSTEM: A SYMPOSIUM SPONSORED BY THE FEDERAL RESERVE BANK OF KANSAS CITY 495, 601–02 (2008).

approach is anathema to financial stability regulation, which requires a long-term perspective that prioritizes the interests of those *outside* of the financial industry.

The political economy cycle thus creates enormous challenges for any regulatory body charged with promoting financial stability, particularly because it is almost impossible to demonstrate when financial stability regulation is making a difference within such a complex system—“[h]ow can a regulatory agency show that a financial crisis would have occurred *but for* its efforts?”⁹⁰ Furthermore, given the complexity and unpredictability of the financial system, regulatory errors are inevitable⁹¹—but financial stability regulation can also succeed (particularly when it is designed to reduce the complexity of the financial system).⁹² If government agencies abdicate their power over the financial system, such power will not dissipate but will accrue to private actors.⁹³ As Pistor phrased it, lack of governmental regulation of financial markets “signifies not the absence of regulation, but the implicit delegation of rule making to different, typically non-state actors,”⁹⁴ and the non-state actors that tend to fill the power vacuum in the financial sphere tend to be financial institutions with neither the ability, nor the inclination, to address the endogenous risks that destabilize the financial system and cause externalities for the world beyond the financial sector.⁹⁵ Financial regulators, and financial stability regulation, are thus critical to protecting society’s long-term interest in financial stability.

C. The Inadequacies of a Purely Ex Post-Focused Approach to Financial Stability Regulation

It can be tempting for regulators to eschew unpopular financial stability regulation when the economy is booming, knowing that if and when a crisis occurs, there is likely to be overwhelming political support for remedial

⁹⁰ Allen, *supra* note 31, at 190.

⁹¹ McDonnell and Schwarcz cite the capital adequacy standards set forth in Basel II as an example of “deeply considered and deliberate decisions guided by the most sophisticated understandings of the economy” that still went wrong. Brett McDonnell & Daniel Schwarcz, *Regulatory Contrarians*, 89 N.C. L. REV. 1629, 1641 (2011). Regulations can also be destabilizing to the extent that they encourage uniformity and thus heighten procyclicality and correlation of risks. For a detailed discussion of this issue, see generally Charles K. Whitehead, *Destructive Coordination*, 96 CORNELL L. REV. 323 (2011).

⁹² See *infra* text accompanying notes 124–30.

⁹³ Short, *supra* note 83, at 680 (citation omitted).

⁹⁴ Katharina Pistor, *A Legal Theory of Finance*, 41 J. COMP. ECON. 315, 321 (2013).

⁹⁵ “Systemic risk regulation is an example where regulators cannot look to private regulatory strategies. Regulators cannot expect that private actors will be capable of identifying how the actions of individual firms may make the financial system less stable.” Eric J. Pan, *Understanding Financial Regulation*, 4 UTAH L. REV. 1897, 1941 (2012).

measures.⁹⁶ However, these *ex post* emergency measures can be limited in their efficacy, as well as generate their own social costs. A purely *ex post* approach to financial stability regulation is thus undesirable.⁹⁷ To illustrate this point, this Part will briefly explore and analyze the different types of *ex post* measures available. To be clear, despite evincing a preference for proactive measures to promote financial stability, this Article is not rejecting *ex post* measures outright. Proactive regulations will never do a perfect job of maintaining financial stability, and some form of the *ex post* mitigative interventions discussed below may still be necessary⁹⁸ (although care is required to ensure that, in accepting the potential need for *ex post* measures, we do not institutionalize fatalism about financial crises, or discourage the refinement of *ex ante* measures). The aim of proactive financial stability regulation is to minimize the need for the following types of *ex post* interventions.

Central banks (like the Federal Reserve) are often the “first responders” to financial crises—they tend to be very accommodating in their monetary policy during and in the aftermath of a crisis, lowering interest rates to encourage borrowing and spending.⁹⁹ Central banks can also attempt to lubricate the financial system in ways that cannot be strictly characterized as monetary policy, but lie in a hazy area somewhere in-between monetary policy, market participation, and regulation.¹⁰⁰ These functions include acting as lender of last resort (i.e., lending to banks when no other source of liquidity is available)¹⁰¹ or, as we saw during the last Financial Crisis, acting as market-maker of last resort (i.e., buying assets to create liquidity when there is no other buyer).¹⁰² Unfortunately, these policies (even if necessary) have social costs: extended periods of low interest rates in the wake of the Financial Crisis have made it difficult for senior citizens and others to live off their savings, which has increased demand for riskier assets with higher yields, making the

⁹⁶ Levitin, *supra* note 81, at 439.

⁹⁷ Joseph Stiglitz, *Regulation and Failure*, in NEW PERSPECTIVES ON REGULATION 13, 24 (David Moss & John Cisternino eds., 2009).

⁹⁸ “[E]ven the most rigorously constructed *ex ante* regulatory measures cannot prevent the financial system from experiencing periodic crises.” Anabtawi & Schwarcz, *supra* note 72, at 96.

⁹⁹ Monetary policy is formulated and implemented by central banks, and is primarily effected by way of asset purchases and the setting of interest rates. *What is the Difference Between Monetary Policy and Fiscal Policy, and How Are They Related?*, BD. GOVERNORS FED. RES. SYS., http://www.federalreserve.gov/faqs/money_12855.htm [<http://perma.cc/P8WR-9H65>] (last updated Oct. 30, 2014).

¹⁰⁰ Rosa M. Lastra, *Central Bank Independence and Financial Stability*, 18 ESTABILIDAD FINANCIERA 49, 59 (2010).

¹⁰¹ *Id.* at 61.

¹⁰² Robert C. Hockett & Saule T. Omarova, “Private” Means to “Public” Ends: Governments as Market Actors 6–7 (Cornell Law Sch. Legal Studies, Research Paper No. 13-84, 2013), <http://ssrn.com/abstract=2222444> [<http://perma.cc/8AWC-ES2Y>].

populace more susceptible to financial fraud¹⁰³ and increasingly questionable securities investments.¹⁰⁴ Financial institutions are also searching for higher yields in this prolonged low-interest rate environment, and have started making funds available to corporations on riskier terms,¹⁰⁵ potentially sowing the seeds for future instability.¹⁰⁶ Future instability may also result from expectations that the Federal Reserve will intervene as a lender of last resort (or market-maker of last resort), just as it has in the past: such expectations encourage financial institutions to take outsized risks that they would never have taken without the implicit promise of support in the event of failure.¹⁰⁷ In addition to these side-effects of *ex post* central bank intervention, there are also questions about its efficacy. The ability of monetary policy to stimulate growth is the subject of hot debate at present,¹⁰⁸ with many arguing that there is only so much that central banks can achieve in the wake of a serious crisis.¹⁰⁹

Instability tends to generate political pressure for elected governments to intervene as well. Assuming that a government reacts to this pressure (and it

¹⁰³ Nathaniel Popper, *Speculative Bets Prove Risky as Savers Chase Payoff*, N.Y. TIMES (Feb. 10, 2013), http://www.nytimes.com/2013/02/11/business/wave-of-investor-fraud-extends-to-ordinary-retirement-savers.html?_r=0 [<http://perma.cc/36CM-5NWK>].

¹⁰⁴ Kevin Roose, *The Age of Bullshit Investments Is Back*, NYMAG.COM (Oct. 23, 2013), <http://nymag.com/daily/intelligencer/2013/10/crazy-investment-time-again.html> [<http://perma.cc/H8NC-V8KV>].

¹⁰⁵ “[M]y reading of the evidence is that we are seeing a fairly significant pattern of reaching-for-yield behavior emerging in corporate credit.” Jeremy C. Stein, Governor, Fed. Reserve Bank, Speech at the “Restoring Household Financial Stability after the Great Recession: Why Household Balance Sheets Matter” Research Symposium, Overheating in Credit Markets: Origin, Measurement, and Policy Responses (Feb. 7, 2013) (transcript available at <http://www.federalreserve.gov/newsevents/speech/stein20130207a.htm> [<http://perma.cc/MU7G-FMJP>]). Of particular concern is the leveraged loan market. Mark Gongloff, *Credit Bubble Comeback: Feds Warn of Dangers in Leveraged Loan Market*, HUFFINGTON POST (Mar. 22, 2013), http://www.huffingtonpost.com/2013/03/22/credit-bubble-leveraged-loan_n_2932421.html [<http://perma.cc/B9TC-HUWC>].

¹⁰⁶ William R. White, *Should Monetary Policy “Lean or Clean”?* 10 (Fed. Reserve Bank of Dall. Globalization and Monetary Pol’y Inst., Working Paper No. 34, 2009), <http://www.dallasfed.org/assets/documents/institute/wpapers/2009/0034.pdf> [<http://perma.cc/GDG4-UVJJ>].

¹⁰⁷ This is often referred to as “moral hazard.” Donald C. Langevoort, *Chasing the Greased Pig Down Wall Street: A Gatekeeper’s Guide to the Psychology, Culture, and Ethics of Financial Risk Taking*, 96 CORNELL L. REV. 1209, 1210–11 (2011).

¹⁰⁸ In 2013, the exclusive and influential Economic Policy Symposium in Jackson Hole was devoted to the “Global Dimensions of Unconventional Monetary Policy.” *Global Dimensions of Unconventional Monetary Policy*, FED. RESERVE BANK KAN. CITY (Aug. 22–24, 2013), <https://www.kansascityfed.org/publications/research/escp/symposiums/escp-2013> [<https://perma.cc/ZFG5-U4NR>]. This is a testament to the status of the efficacy of monetary policy as a “hot topic.”

¹⁰⁹ White, *supra* note 106, at 9.

may not,¹¹⁰ with governmental inaction exacerbating the crisis at hand),¹¹¹ governmental crisis management can take the form of bailing out systemically important financial institutions (SIFIs)¹¹² (with attendant moral hazard), as well as the deployment of emergency fiscal policy options. While there are many different ways in which a government can decide to tax and spend post-crisis, broadly speaking, there are two types of fiscal policy options available. First, the government can attempt to stimulate demand by tax cuts, spending, or both (the Keynesian option).¹¹³ Alternatively, it can try to encourage private spending by cutting back on government spending: referred to as the austerity option, the expectation here is that fiscal discipline by the government will inspire confidence about the state's long-term viability and encourage private investment.¹¹⁴ Either option entails social costs: while stimulus is intended to create demand and jumpstart the economy in the short-term (and thus ameliorate the immediate pain occasioned by financial crises), the stimulus will increase the public deficit.¹¹⁵ Over time, increasing public debt can undermine a government's ability to borrow, potentially compromising the government's ability to fund future activities.¹¹⁶ In contrast, austerity programs impose social costs in the short-term by cutting back on government spending immediately.¹¹⁷ Although this Article will not weigh into the very

¹¹⁰ Katharina Pistor commented:

When staring into the abyss of a financial collapse, politicians like bureaucrats may opt for rescue rather than self-destruction. As the showdown over the bailout package in the U.S. in September 2008 (when Congress voted down the first version of the law) has shown, however, this is by no means a foregone conclusion.

Pistor, *supra* note 94, at 328.

¹¹¹ Lack of government action can be costly: "[W]hen dealing with markets, gradual action may be counterproductive because there is a specter of something bad, like bankruptcy, nationalization, or other types of asset sales, happening at the end. This uncertainty breeds inaction and might make the problem much worse." Phillip Swagel, *The Financial Crisis: An Inside View*, 2009 BROOKINGS PAPERS ON ECON. ACTIVITY 75 (2009), http://www.brookings.edu/~media/Projects/BPEA/Spring-2009/2009a_bpea_swagel.PDF [<http://perma.cc/996P-ZA8C>]. "[T]he costs of the failure of intervention are typically on an order of magnitude greater than the costs of the interventions themselves." Stiglitz, *supra* note 97, at 14.

¹¹² For example, the U.S. Government invested \$431 billion in banks pursuant to the TARP (Troubled Asset Relief Program) program. CONG. BUDGET OFFICE, REPORT ON THE TROUBLED ASSET RELIEF PROGRAM—MAR. 2012, at 1 (2012), <https://www.cbo.gov/sites/default/files/112th-congress-2011-2012/reports/03-28-2012TARP.pdf> [<https://perma.cc/WX5B-V2DU>].

¹¹³ Schizer, *supra* note 39, at 461.

¹¹⁴ Carmen M. Reinhart & Kenneth S. Rogoff, *Growth in a Time of Debt*, 100 AM. ECON. REV. 573, 577–78 (2010).

¹¹⁵ Schizer, *supra* note 39, at 467.

¹¹⁶ *Id.* at 467–68.

¹¹⁷ See, e.g., Liz Alderman, *In Ireland, Austerity Is Praised but Painful*, N.Y. TIMES (Dec. 5, 2011), <http://www.nytimes.com/2011/12/06/business/global/despite-praise-for-its-austerity-ireland-and-its-people-are-being-battered.html> [<http://perma.cc/4MAE-KVFT>];

active debate about austerity versus stimulus,¹¹⁸ these two types of policies are mentioned here to illustrate that *ex post* fiscal remedies (whether Keynesian or austere) always impose costs on society.

Traditionally, financial regulatory agencies have tended to play less of a role than central banks and governments in immediate crisis response. While regulation will often be retooled to reflect the lessons of a crisis, this usually takes time and does little to ease the constraints on the availability of credit that characterize the immediate aftermath of financial crises.¹¹⁹ However, if countercyclical regulation is broadly implemented, agencies like the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) will be expected to play a much more active role in crisis management by making the rules that govern financial institutions much more permissive in bust times.¹²⁰ Whilst countercyclical regulation does hold promise in terms of enabling regulators to ease restrictions on credit availability in the wake of a crisis, it also entails making regulation more demanding in boom times;¹²¹ countercyclical regulation does not work as a purely *ex post* response. As such, regulators will also need to focus on financial stability issues even when the economy seems to be functioning well.

D. Complexity and Efficiency: Potential Problems with a Proactive Approach to Financial Instability

Of course, a proactive approach to financial stability regulation is not costless. One concern is that the regulations themselves are new “inputs” into the financial system, and that the more inputs we add, the more complex—and less stable—the financial system will be.¹²² Furthermore, new regulation often inspires the creation of new products and institutions developed to arbitrage those regulatory requirements, further compounding the complexity of the financial system.¹²³ However, this is not an inevitable result: if designed well,

Liz Alderman, *More Children in Greece Are Going Hungry*, N.Y. TIMES (Apr. 17, 2013), <http://www.nytimes.com/2013/04/18/world/europe/more-children-in-greece-start-to-go-hungry.html> [<http://perma.cc/X3SK-PQR3>]; Suzanne Daley, *Fiscal Crisis Takes Toll on Health of Greeks*, N.Y. TIMES (Dec. 26, 2011), <http://www.nytimes.com/2011/12/27/world/europe/greeks-reeling-from-health-care-cutbacks.html> [<https://perma.cc/3T47-UEPS>]; Raphael Minder, *Education Cuts Met with Strike in Spain*, N.Y. TIMES (May 22, 2012), <http://www.nytimes.com/2012/05/23/world/europe/education-and-health-care-cuts-met-with-strike-in-spain.html> [<http://perma.cc/R9XZ-VU5Q>].

¹¹⁸ See, e.g., Eduardo Porter, *A Keynesian Victory, but Austerity Stands Firm*, N.Y. TIMES (May 21, 2013), <http://www.nytimes.com/2013/05/22/business/despite-keynesians-victory-economic-policy-holds.html> [<https://perma.cc/VB3K-QDTN>].

¹¹⁹ See Anabtawi & Schwarcz, *supra* note 72, at 211–12.

¹²⁰ See *supra* note 69 and accompanying text.

¹²¹ Hockett, *supra* note 69, at 227.

¹²² For a discussion of the destabilizing effects of complexity, see generally Hilary J. Allen, *The Pathologies of Banking Business As Usual*, 17 U. PA. J. BUS. L. 861 (2015).

¹²³ Anabtawi & Schwarcz, *supra* note 72, at 100–01.

ex ante financial stability regulation can instead mitigate the financial system's spiral into complexity.¹²⁴ One way to limit arbitrage and its attendant complexity would be for the regulatory "burden of proof" to be shifted to the financial industry, so that industry participants would be required to demonstrate why they should be allowed to create new products and engage in new activities, instead of the regulators being forced to play an under-resourced game of catch-up with the industry.¹²⁵ As I have argued previously, such an approach is well-calibrated to minimize the number of new inputs into the financial system.¹²⁶ Other scholars have argued that complexity could be reduced by breaking up "too big to fail" banks.¹²⁷ Unfortunately, both of the aforementioned approaches are likely to face (at least at present) insurmountable opposition from the financial industry. There are, however, other—potentially more politically feasible—regulatory approaches that can limit the increase of complexity. In particular, favoring broad and simple regulations over detailed and complex ones can be particularly useful in promoting financial stability.¹²⁸ Not only are broad and simple rules more difficult to arbitrage, they are also more appropriate because they are "robust to [the] ignorance" inherent in complex and uncertain systems¹²⁹—that is, they are not tailored in too detailed a way to reflect the lessons of past experience (which are often not a predictor of future crises).¹³⁰ In sum, while *ex ante* financial stability regulations can result in increased complexity and attendant compromised stability, they can also be designed to avoid or minimize this eventuality.

Others have argued against a proactive approach to financial stability regulation on the grounds that "pursuing *ex ante* regulation as the only, or even primary, regulatory strategy aimed at controlling systemic risk would be

¹²⁴ It is also naïve to suggest that complexity would not deepen in the absence of regulation: exceedingly complex over-the-counter derivatives developed in the largely unregulated space carved out by the Commodity Futures Modernization Act of 2000. Kristin N. Johnson, *Things Fall Apart: Regulating the Credit Default Swap Commons*, 82 U. COLO. L. REV. 167 (2011).

¹²⁵ Allen, *supra* note 31, at 179.

¹²⁶ *Id.* at 222.

¹²⁷ See, e.g., JOHNSON & KWAK, *supra* note 64, at 214–17.

¹²⁸ By way of example, Haldane and Madouros have suggested the following ways in which capital adequacy requirements might be simplified: removing internal risk-based models from the Basel capital adequacy architecture; increasing (and relying more heavily) on a simple leverage ratio; and allowing more scope for regulatory discretion. Andrew G. Haldane, Exec. Dir., Fin. Stability & Vasileios Madouros, Economist, Bank of Eng., Speech at the Federal Reserve Bank of Kansas City's 36th Economic Policy Symposium: The Changing Policy Landscape, The Dog and the Frisbee 14–17 (Aug. 31, 2012) (transcript available at <http://www.kansascityfed.org/publicat/sympos/2012/ah.pdf> [<https://perma.cc/AA5A-8KBH>]).

¹²⁹ *Id.* at 3.

¹³⁰ *Id.* at 4.

inefficient.”¹³¹ However, directing regulators to prioritize efficiency lends credence to those who seek less-regulated capital flows, even at the expense of financial stability. This Article argues, to the contrary, that regulators need a clear direction that the primary normative goal of financial regulatory policy is the *ex ante* pursuit of financial stability. Whilst efficiency is a relevant concern, it is of lesser importance than financial stability.¹³²

Any analysis of the relative importance of financial stability and efficiency as goals for financial regulation raises the threshold issue of what is meant by “efficiency.”¹³³ Efficiency, as a normative goal of regulation, is usually interpreted to mean optimal allocative efficiency,¹³⁴ in the Kaldor–Hicksian sense that “the aggregate economic benefits exceed the aggregate economic costs, even though some market participants may bear costs on net while others reap benefits on net.”¹³⁵ On its face, allocative efficiency may seem like an appropriate end goal for regulation of the financial system (after all, the system exists largely for the purpose of allocating capital resources and risk).¹³⁶ However, a Kaldor–Hicksian analysis of the financial system fails to consider distributional inequalities within that system¹³⁷: many of the capital resources distributed are recycled amongst financial institutions in what Lothian has termed “financial hypertrophy,” whereas lesser amounts of capital

¹³¹ Anabtawi & Schwarcz, *supra* note 72, at 102.

¹³² “Things happen during a speculative bubble that can ruin people’s lives. Little will be done to stop these things if public figures consider themselves beholden to some overarching efficient markets principle.” ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* 212 (2d ed. 2005). In a similar vein, Driesen has argued that the avoidance of systemic risk (while still allowing for economic growth) is “both more meaningful and more achievable than the goal of economic efficiency.” David M. Driesen, *Legal Theory Lessons from the Financial Crisis*, 40 J. CORP. L. 55, 91 (2014).

¹³³ “A major problem with the debates on efficiency in markets and capital market policy has been the lack of a clear efficiency rationale.” Gill North & Ross P. Buckley, *A Fundamental Re-Examination of Efficiency in Capital Markets in Light of the Global Financial Crisis*, 33 U. NEW S. WALES L.J. 714, 741 (2010).

¹³⁴ DAVID M. DRIESEN, *THE ECONOMIC DYNAMICS OF LAW* 20 (2012); Anabtawi & Schwarcz, *supra* note 72, at 90; Stiglitz, *supra* note 97, at 14.

¹³⁵ Yoon-Ho Alex Lee, *The Efficiency Criterion for Securities Regulation: Investor Welfare or Total Surplus?*, 57 ARIZ. L. REV. 85, 87 (2015).

¹³⁶ Financial market theory in the decades preceding the Financial Crisis was premised on the assumption that allocative efficiency enabled “providers and users of funds more effectively to meet their preferences for risk, return and liquidity.” FIN. SERVS. AUTH., *THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS* 40 (Mar. 2009) [hereinafter *THE TURNER REVIEW*], http://www.fsa.gov.uk/pubs/other/turner_review.pdf [<http://perma.cc/BY3G-8LWK>].

¹³⁷ Lee, *supra* note 135, at 87. For similar reasons, Kaplow and Shavell reject wealth maximization and efficiency criteria as the sole criteria for assessing rules to the extent that they omit “important aspects of individuals’ well-being” and ignore distributive concerns. Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961, 968 (2001).

flow to more productive uses by households and non-financial businesses.¹³⁸ If the financial system exists to promote broad-based economic growth, and not just capital appreciation, then the way that capital is distributed matters.¹³⁹ Furthermore, the concentration of resources within the financial system is problematic for financial stability because “the very size of financial markets thus created pushes the limits of what sovereigns are willing or able to provide,” in terms of backing and emergency support in times of crisis.¹⁴⁰ However, according to the Kaldor–Hicks model, there is no problem with this type of capital allocation.¹⁴¹

The criterion of efficiency has also been criticized as an ineffectual standard for evaluating something as complex as financial stability regulation. Driesen, for example, argues that financial regulation does not control the allocation of capital, but instead creates a framework within which capital is allocated.¹⁴² Although the regulatory framework certainly influences capital allocation, there are many other variables—outside of the control of regulation—that also influence capital allocation. Because the influence of these different variables cannot be isolated, Driesen argues that optimal allocative efficiency is not a yardstick by which financial regulation can be measured.¹⁴³ Furthermore, when regulation is assessed to determine whether it promotes efficiency, such assessment usually involves some form of

¹³⁸ Lothian has described “financial hypertrophy” as the “expansion of the financial sector (measured by the proportion of talent, as well as resources and profits that it absorbs) without regard to the service extended to the real economy.” Tamara Lothian, *American Finance and American Democracy: Towards an Institutional “Law and Economics,”* 7–8 (Columbia Law Sch. Working Paper Series, Working Paper No. 418, 2012), <http://ssrn.com/abstract=1996653> [<http://perma.cc/5H43-8B8L>].

¹³⁹ Lothian contrasts financial hypertrophy with financial deepening:

By financial deepening, I mean the increase of the service that finance renders to the expansion of productive output and the enhancement of productivity. By financial hypertrophy, I mean the expansion of the size of the financial industry, as a proportion of national income or profits as well as a magnet for talent, without a corresponding reinforcement of support for the expansion of output and the enhancement of productivity. The concept of financial hypertrophy, as I propose to use it, is therefore parasitic on the concept of financial deepening. Financial hypertrophy is the expansion of finance without financial deepening.

Id.

¹⁴⁰ Pistor, *supra* note 94, at 323.

¹⁴¹ Stiglitz, *supra* note 97, at 14. Black notes that the use of such economic models to assess the financial system is not merely a passive evaluation, but also drives how the system functions. Julia Black, *Reconceiving Financial Markets—From the Economic to the Social*, 13 J. CORP. L. STUD. 401, 432 (2013). Using a model that is insensitive to capital distribution will exacerbate any tendency of the financial system to work in a similarly insensitive way. *Id.* at 435.

¹⁴² Driesen, *supra* note 132, at 56.

¹⁴³ *Id.*

quantified cost–benefit analysis.¹⁴⁴ Unfortunately, quantified cost–benefit analysis is ill-suited to assessing financial stability regulation for a number of reasons. First, it gives us little guidance as to the stakeholders that should be considered in the analysis¹⁴⁵: when trying to assess costs and benefits, should we consider only the financial institutions that populate the financial system (and their counterparties), or should regulation also be concerned with those who suffer from externalities generated by those financial institutions? Even if it were accepted that cost–benefit analysis should consider the benefits to the latter type of stakeholders, it is very difficult to quantify the social benefits of avoiding instability,¹⁴⁶ and to show that instability would have occurred *but for* the regulatory intervention.¹⁴⁷ It is much easier to assign a dollar value to industry compliance costs, and so a paramount focus on efficiency and cost–benefit analysis is likely to favor the absence of financial stability regulation,¹⁴⁸ even when such a deregulatory approach is likely to entail large social costs. When dealing with the broad social costs of financial crises and how they are distributed, cost–benefit analysis is therefore an inapt tool.¹⁴⁹

Of course, “efficiency” need not be defined solely in reference to optimal allocative efficiency, and quantified cost–benefit analysis need not be the only tool used to evaluate financial regulation. If “inefficiency” were conceptualized as including any situation where financial institutions generate externalities that negatively impact the broader economy (including in ways that are difficult—if not impossible—to quantify), then “inefficiency” and “financial instability” would describe largely the same state of affairs. This Part could then be accused of setting up a false dichotomy between stability and efficiency. However, efficiency is not usually conceived of in so broad a fashion.¹⁵⁰ Instead, regulation promoting efficiency tends to neglect the

¹⁴⁴ “[Q]uantified CBA in its ideal form—which some of its advocates refer to as ‘complete’ quantified CBA—entails specification and quantification of all benefits and costs in a single, uniform bottom-line metric (typically, dollars) representing the net welfare effects of a proposed rule.” John C. Coates IV, *Cost–Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 893 (2015) (footnote omitted) (citing Letter from Nancy Nord et al. to Thomas R. Carper, Chair of the Senate Homeland Sec. and Gov’t Affairs Comm., and Thomas A. Coburn, Ranking Member of the Senate Homeland Sec. and Gov’t Affairs Comm. 2 (June 18, 2013), http://www.portman.senate.gov/public/index.cfm/files/serve?File_id=8eb0dbd9-5631-4878-bfb2-e040407cf0ba [<http://perma.cc/BB9B-HER8>]).

¹⁴⁵ Lee, *supra* note 135, at 117–18.

¹⁴⁶ “[F]inancial products affect nearly every activity of all citizens on a daily basis,” which further complicates any attempt to capture the overall effect of regulation. *Id.* at 107.

¹⁴⁷ Allen, *supra* note 31, at 190–91.

¹⁴⁸ *Id.*

¹⁴⁹ Lee asserts that cost–benefit analysis is inapt for assessing distributional concerns. Lee, *supra* note 135, at 102.

¹⁵⁰ North & Buckley, *supra* note 133, at 716. Anabtawi and Schwarcz also note that the social costs of financial instability are sometimes conceived of as being “encompassed under a broad view of economic efficiency,” but then go on to say that “they are sometimes

externalities of financial system failure that are imposed on persons outside of the financial system,¹⁵¹ who are nonetheless affected by the movements of the broader economy (such as “laborers whose jobs would be lost” when economic growth stalls after a financial crisis).¹⁵² It also neglects the disproportionate externalities of an economic downturn borne by those who do participate in the financial system, but only in a minor, uncomplicated way (for example, “pension holders whose pension funds would be eviscerated by excessive risk taking”).¹⁵³ Although many believed prior to the Financial Crisis that the financial system was efficiently allocating risk to those within the system who were most willing to bear it, in fact much of that risk was being externalized outside of the financial system to the broader economy,¹⁵⁴ with disastrous social consequences.

As such, financial regulation should be primarily informed by a normative goal that is more inclusive than optimal allocative efficiency, and that promotes general societal well-being in a way that is somewhat sensitive to distributional inequalities.¹⁵⁵ An acceptance of this normative position is often implicit in *ex post* responses to financial crises, when efficiency concerns tend to be abandoned in favor of interventionist policies that seek to promote social welfare.¹⁵⁶ As Lothian has noted, the current state of affairs is that “[e]verything happens, in the realm of ideas and of public debate as if the market fundamentalist view were the economics of normal times and the Keynesian view, the economics of crises and recession.”¹⁵⁷ However, as this Part has already explored, by the time a crisis erupts, it is too late to avoid many of the negative externalities caused by financial instability. The

regarded as implicating non-efficiency considerations.” Anabtawi & Schwarcz, *supra* note 72, at 90.

¹⁵¹ As Schwarcz puts it, “Even though systemic risk is a form of financial risk, it stands apart and should be differentiated from traditional financial risk. Traditional financial risk focuses on risks *within* the financial system, and so efficiency should be the central goal. Conversely, systemic risk focuses on risks *to* the financial system.” Stephen L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 207 (2008).

¹⁵² Stiglitz, *supra* note 97, at 20.

¹⁵³ *Id.*

¹⁵⁴ THE TURNER REVIEW, *supra* note 136, at 42.

¹⁵⁵ Stiglitz, *supra* note 97, at 15. In a similar vein, Driesen notes, “This efficiency focus remains predominant even though scholars have cast doubt on allocative efficiency’s normative value.” Driesen, *supra* note 132, at 62.

¹⁵⁶ As to the lack of cost-benefit rationale offered for bailouts in 2008, see Driesen, *supra* note 132, at 92. Similarly, when the Securities and Exchange Commission (SEC) temporarily banned all short selling of stock in financial institutions in the wake of the Lehman Brothers collapse, there was no mention of cost-benefit analysis (or indeed, of costs at all). See Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, 73 Fed. Reg. 55,169 (Sept. 18, 2008).

¹⁵⁷ Tamara Lothian, *Beyond Macro-Prudential Regulation: Three Ways of Thinking About Financial Crisis, Regulation and Reform* 12 (Columbia Law Sch. Working Paper Series, Paper No. 411, 2011), <http://ssrn.com/abstract=1961369> [<http://perma.cc/96EE-9WZ5>].

acceptance of financial stability as the chief normative goal of regulation needs to exist in good times as well as bad.

All of this is not to say that regulation should ignore efficiency concerns entirely. Efficient markets allow “providers and users of funds more effectively to meet their preferences for risk, return and liquidity,” and in circumstances where the normative goals of efficiency and financial stability are compatible, regulation should aim to promote efficiency.¹⁵⁸ However, the pursuit of efficiency (especially in the short-term) will often be detrimental to financial stability, and vice versa.¹⁵⁹ In these instances, financial regulators will need to decide to what extent either efficiency or stability should be sacrificed, and while regulators should not be so precautionary that they ban *any* activity that could potentially harm financial stability, financial regulators need to have a clear hierarchy of priorities that instructs them to err on the side of protecting the smooth functioning of the financial system.¹⁶⁰ At present, however, only one of the many financial regulatory agencies in the United States is charged with a statutory mandate to pursue financial stability as its paramount goal: the FSOC. The next Part provides an introduction to this new agency, before Part IV considers whether it is up to its vitally important task.

III. MEET THE FSOC

Instead of rationalizing the byzantine structure of the United States’ financial regulatory agencies, or giving any of these existing agencies a financial stability mandate,¹⁶¹ the Dodd–Frank legislation enacted in 2010 created a council of the heads of various existing agencies¹⁶² named the “Financial Stability Oversight Council,”¹⁶³ and bestowed on that council alone an express statutory mandate to promote financial stability.¹⁶⁴ In the five years

¹⁵⁸ THE TURNER REVIEW, *supra* note 136, at 40.

¹⁵⁹ For example, new financial products that seek to improve efficiency by providing ever more bespoke methods of allocating risk and creating liquidity can create destabilizing complexity. “It is for instance arguable that the allocative efficiency benefits of the creation of markets for many complex structured [products] (e.g., CDO-squareds) would have been at most trivial even if they had not played a role in creating financial instability.” *Id.* at 41.

¹⁶⁰ Allen, *supra* note 31, at 204.

¹⁶¹ *Who Is Too Big to Fail? GAO’s Assessment of the Financial Stability Oversight Council and the Office of Financial Research: Hearing Before the Subcomm. on Oversight & Investigations of the H. Comm. on Fin. Servs.*, 113th Cong. 65–88 (2013) (statement of A. Nicole Clowers, Director, Financial Markets and Community Investment) [hereinafter Clowers Statement].

¹⁶² The FSOC also has an independent member with insurance expertise, who does not represent any federal agency. Dodd–Frank Act § 111(b)(1)(j), 12 U.S.C. § 5321 (2012).

¹⁶³ *Id.* § 111.

¹⁶⁴ *Id.* § 112(a). “The Financial Stability Oversight Council has a clear statutory mandate that creates for the first time collective accountability for identifying risks and responding to emerging threats to financial stability.” Fin. Stability Oversight Council, *About FSOC: Frequently Asked Questions*, U.S. DEP’T TREASURY, <http://www.treasury.gov/initiatives/>

since it was created, surprisingly little academic attention has been paid to the FSOC's mandate, or to how it will or should carry out its functions (other than the current furor over its designation powers).¹⁶⁵ Furthermore, there has been almost no discussion of how inserting a new administrative body into the financial regulatory mix will impact the existing regulatory apparatus.¹⁶⁶ This Part will provide an introduction to the FSOC that will allow the rest of this Article to engage in a more fulsome discussion of these issues.

The FSOC is a council of the officials who lead the federal financial regulatory agencies. Each of the Chairman of the Federal Reserve, the Comptroller of the Currency, the Chairperson of the FDIC, the Director of the Consumer Financial Protection Bureau (CFPB), the Chairman of the SEC, the Chairman of the Commodity Futures Trading Commission (CFTC), the Director of the Federal Housing Finance Agency and the Chairman of the National Credit Union Administration Board is a voting member of the FSOC, as is "an independent member appointed by the President, by and with the advice and consent of the Senate, having insurance expertise."¹⁶⁷ The FSOC also has five non-voting members: the Director of the Office of Financial Research, the Director of the Federal Insurance Office, and representative state banking, insurance and securities commissioners.¹⁶⁸ Finally, the Treasury Secretary is a voting member, and also acts as the Chair of the FSOC.¹⁶⁹ Although the FSOC's members (and the agencies they lead) have not been individually charged with express financial stability mandates, pursuant to section 112(b) of Dodd-Frank, each voting member is required to submit an annual statement to Congress outlining its views on extant threats to financial stability.

The FSOC is distinguishable from the more substantial regulatory bodies led by its members because it has only a small dedicated staff,¹⁷⁰ and a

fsoc/about/Pages/default.aspx [http://perma.cc/29UM-3F22] (last updated May 19, 2015) [hereinafter *FSOC FAQs*].

¹⁶⁵ See *supra* note 8 and accompanying text.

¹⁶⁶ This is an important question because, inevitably, "the organization of the administrative system affects the substance of regulation." Keith Bradley, *The Design of Agency Interactions*, 111 COLUM. L. REV. 745, 748 (2011).

¹⁶⁷ Dodd-Frank Act § 111(b)(1).

¹⁶⁸ *Id.* § 111(b)(2).

¹⁶⁹ *Id.* § 111(b)(1).

¹⁷⁰ As of June 2012, there were twenty-five staff in the "dedicated policy office within the Treasury's Office of Domestic Finance . . . which functions as the FSOC Secretariat." U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-886, FINANCIAL STABILITY: NEW COUNCIL AND RESEARCH OFFICE SHOULD STRENGTHEN THE ACCOUNTABILITY AND TRANSPARENCY OF THEIR DECISIONS 12 (2012), <http://www.gao.gov/assets/650/648064.pdf> [http://perma.cc/B68K-N346] [hereinafter GAO-12-886]. In addition, the Independent Member of the FSOC with Insurance Expertise, together with his or her small staff, are FSOC staff members. *Id.* at 5, 60.

relatively small budget.¹⁷¹ Whilst Dodd–Frank did create an Office of Financial Research (OFR) to lend data-gathering and analytical support to the FSOC, the FSOC does not have substantial resources to implement policies reflecting the OFR’s research.¹⁷² For these reasons, some have suggested that the FSOC is just a communication and coordination forum, a formal (albeit more transparent and inclusive) continuation of the President’s Working Group on Financial Markets that existed pre-Dodd–Frank.¹⁷³ However, Dodd–Frank grants the FSOC a number of important powers that the President’s Working Group did not have. These can be divided into two categories: powers over private entities and powers over other agencies. With regard to the former, pursuant to section 113 of Dodd–Frank, the FSOC is responsible for determining the non-bank financial companies that pose sufficient risk to financial stability that should be subjected to heightened supervision and regulation by the Federal Reserve.¹⁷⁴ The FSOC also has a similar power with respect to financial market utilities.¹⁷⁵ These designation powers have been called “[b]y far the FSOC’s most important substantive function.”¹⁷⁶

With regard to the powers that the FSOC has over the other financial regulatory agencies, these include section 119, which allows the FSOC to resolve (with a non-binding recommendation) disputes amongst other agencies, and section 1023, which allows the FSOC to invalidate any rulemaking made by the CFPB that the FSOC deems threatening to stability. At the weaker end of the spectrum is the FSOC’s power pursuant to section 112(d) to request, but not compel, information from individual agencies. Perhaps the most important of the FSOC’s powers over the financial agencies is section 120, which authorizes the FSOC to make recommendations that an

¹⁷¹ The FSOC’s proposed budget for Financial Year 2015 was \$8,690,355. Fin. Stability Oversight Council, *FSOC Budget Information*, U.S. DEP’T TREASURY, <http://www.treasury.gov/initiatives/fsoc/governance-documents/Documents/FSOC%20Budget%20Information%20for%20Fiscal%20Year%202015.pdf> [<http://perma.cc/ZZ5N-76M7>].

¹⁷² It has also been argued that section 152(a) of Dodd–Frank, which makes the OFR a department of the Treasury rather than an independent office, has rendered the OFR highly susceptible to political concerns and capture. Simon Johnson, *The Disappointing Office of Financial Research*, N.Y. TIMES (Jan. 30, 2014), http://economix.blogs.nytimes.com/2014/01/30/the-disappointing-office-of-financial-research/?_r=1 [<http://perma.cc/HY2R-SBQQ>].

¹⁷³ Donald N. Lamson & Hilary Allen, *Financial Stability Oversight Council: Completely New or Deja Vu?*, 96 BNA’S BANKING REP. 974 (May 24, 2011).

¹⁷⁴ To date, the FSOC has designated AIG, GE Capital, Prudential, and MetLife as Systematically Important Financial Institutions (SIFIs). William M. Butler, *Falling on Deaf Ears: The FSOC’s Evidentiary Hearing Provides Little Opportunity to Challenge a Nonbank SIFI Designation*, 18 N.C. BANKING INST. 663, 664 (2014); DealBook, *MetLife Formally Challenges “Systemically Important” Designation*, N.Y. TIMES: DEALBOOK (Oct. 3, 2014, 5:08 PM), http://dealbook.nytimes.com/2014/10/03/metlife-formally-challenges-designation-as-systemically-important/?_r=0 [<http://perma.cc/HAU7-ZYQN>].

¹⁷⁵ Dodd–Frank Act § 804, 12 U.S.C. § 5463 (2012).

¹⁷⁶ Stavros Gadinis, *From Independence to Politics in Financial Regulation*, 101 CALIF. L. REV. 327, 369 (2013). For a detailed discussion of how the designation process works, see Butler, *supra* note 174, at 665–72.

agency “apply new or heightened standards and safeguards . . . for a financial activity or practice,” if the FSOC determines that such activity or practice is systemically risky. Because of these powers, some observers have concluded that the FSOC is a “peak-level arbiter” with “strong oversight.”¹⁷⁷ However, some of the financial regulatory agencies have openly declared their resistance to conceding power to the “FSOC¹⁷⁸: for example, the SEC has bluntly stated its view that the FSOC was not designed as a ‘super-regulator.’”¹⁷⁹

The legislative debates regarding Dodd–Frank make it clear that legislators deliberately chose not to give the FSOC a direct power to compel action from any agencies,¹⁸⁰ but the recommendation procedure in section 120 can be viewed as a stick that incentivizes individual agencies to respond to informal suggestions for action.¹⁸¹ Should an agency fail to respond to informal pressure, pursuant to section 120, the FSOC can publicly recommend that certain steps be taken with respect to a particular financial activity or practice (these can range between “limiting its scope, or applying particular capital or risk management requirements to the conduct of the activity or prohibiting the activity or practice”).¹⁸² If the agency in question fails to

¹⁷⁷ Jody Freeman & Jim Rossi, *Agency Coordination in Shared Regulatory Space*, 125 HARV. L. REV. 1131, 1187 (2012).

¹⁷⁸ It should not be surprising that an attempt to impose centralized control over existing financial regulatory agencies might invoke some type of resentment or resistance. See David P. McCaffrey et al., *The Appeal and Difficulties of Participative Systems*, 6 ORG. SCI. 603, 604 (1995).

¹⁷⁹ U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-151, DODD–FRANK ACT REGULATIONS: IMPLEMENTATION COULD BENEFIT FROM ADDITIONAL ANALYSES AND COORDINATION 111 (2011). In response to a report drafted by the GAO on the regulatory implementation of Dodd–Frank, the SEC and the OCC commented “that efforts to improve coordination through FSOC must be balanced with the need to ensure that the independence of each regulator is not affected.” *Id.* at 40.

¹⁸⁰ During a lecture at the University of Pennsylvania Law School, Daniel K. Tarullo commented:

[D]uring the debates preceding Dodd–Frank, some versions of proposals for what eventually became the FSOC would have empowered the FSOC to override agency action or inaction within its sphere of authority. Others, including many who favored strong reforms, opposed this power, which would have created a kind of super-agency with veto authority over all the regulators. Instead, the FSOC has the more limited authority to present an agency with recommendations for action and the right to receive an explanation should the agency not accept those recommendations.

Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Reserve Sys., Remarks at the University of Pennsylvania Law School Distinguished Jurist Lecture, Financial Stability Regulation 25 (Oct. 10, 2012) (transcript available at <http://www.federalreserve.gov/newsevents/speech/tarullo20121010a.htm> [<http://perma.cc/TE5M-SCBZ>]).

¹⁸¹ Discussing interagency interactions, Freeman and Rossi note that: “We suspect that agency officials who wish to get things done can accomplish a great deal through such informal channels. It also seems likely that informal approaches supplement more formal coordination processes.” Freeman & Rossi, *supra* note 177, at 1156.

¹⁸² Dodd–Frank Act § 120(b)(2)(B), 12 U.S.C. § 5330 (2012).

implement the FSOC's recommendations, then it is required to explain in writing to the FSOC why it has failed to do so.¹⁸³ The FSOC is then required to report such failure to Congress, which may result in the relevant agency being called before Congress to explain its position.¹⁸⁴ If the prospect of testifying before Congress is insufficient to force individual agencies to comply with recommendations from the FSOC, Zaring has argued that the likely next step is for the FSOC to designate the key financial institutions that engage in the impugned financial activity as systemically important non-banks pursuant to section 113, thus removing them to the jurisdiction of the Federal Reserve and circumventing the authority of the primary regulatory agency.¹⁸⁵

So far, this discussion of the FSOC's powers (and indeed almost all discussion of the FSOC to date) has conceived of the FSOC as a unified entity. However, this masks the interagency dynamics that are inevitable in a council comprised of multiple regulatory bodies. There is something artificial about discussing the FSOC's powers over the financial regulatory agencies, given that the head of each of those member agencies is part of, and can to some extent direct the actions of, the FSOC. However, not all of the FSOC's members are created equal in terms of their ability to drive the FSOC's agenda: in particular, there are a number of statutory provisions that work to cement the authority of the Secretary of the Treasury within the FSOC. The Treasury Secretary, in addition to chairing the FSOC, is the only member that can, on its own, call a meeting of the FSOC (meetings are otherwise held quarterly, or upon the vote of the majority of the FSOC's members).¹⁸⁶ The Treasury Secretary as chair is also responsible for setting the agenda of any meeting of the FSOC, and for testifying before Congress on behalf of the FSOC.¹⁸⁷ Furthermore, the Treasury Secretary has a *de facto* veto right with respect to designating non-bank financial companies for heightened prudential supervision pursuant to section 113 (and rescinding those designations).¹⁸⁸ As such, by design, Dodd-Frank grants the Treasury Secretary an outsized role in the FSOC's operations.

In addition, the Federal Reserve has long been considered the most preeminent of the financial regulatory agencies,¹⁸⁹ and is likely to be

¹⁸³ *Id.* § 120(c)(2).

¹⁸⁴ *Id.* § 120(d)(2).

¹⁸⁵ David Zaring, *Money Market Fund Overhaul Is Early Test for Dodd-Frank*, N.Y. TIMES: DEALBOOK (May 31, 2013, 2:10 PM), <http://dealbook.nytimes.com/2013/05/31/money-market-fund-overhaul-is-early-test-for-dodd-frank/> [<http://perma.cc/995U-MJ24>].

¹⁸⁶ Dodd-Frank Act § 111(e)(1).

¹⁸⁷ *Id.* § 112(a)(2)(N).

¹⁸⁸ EDWARD V. MURPHY & MICHAEL B. BERNIER, CONG. RESEARCH SERV., R42083, FINANCIAL STABILITY OVERSIGHT COUNCIL: A FRAMEWORK TO MITIGATE SYSTEMIC RISK 7 (2011), <http://www.llsdc.org/assets/DoddFrankdocs/crs-r42083.pdf> [<http://perma.cc/X6JD-FCYY>].

¹⁸⁹ *Improving Financial Institution Supervision: Examining and Addressing Regulatory Capture*, Hearing Before the S. Subcomm. on Fin. Insts. & Consumer Prot. of

particularly assertive with respect to financial stability issues within the FSOC (at least in the short term)¹⁹⁰—even in the absence of any statutory authority to do so. The Federal Reserve and Treasury are also the members of the FSOC that are chiefly responsible for coordinating with foreign regulators and international standard setting bodies on financial stability issues.¹⁹¹ As such, the Treasury and the Federal Reserve seem to be “more equal” than the other members of the FSOC, and when we talk about the prospect of the FSOC exercising power over its members, more often than not we are conceptualizing situations where the Chair of the Federal Reserve or the Secretary of the Treasury might use the FSOC to direct the other agencies to act in a particular way. Alternatively, when an FSOC member represents a commission (such as the SEC or the CFTC), he or she may use the FSOC as a forum for expressing his or her own personal views, rather than the consensus position of the full commission that would otherwise guide the agency.¹⁹² In such instances, the member may be attempting to use the FSOC as a vehicle to effect policy change within their own agency, because they cannot get their fellow commissioners to agree to such policy in the ordinary course.

This discussion of interagency interactions is largely hypothetical. To date, the only real indication we have about how the FSOC will assert its powers over other agencies derives from the regulatory haggling over money market mutual fund (MMF) reform. By way of background, Mary Schapiro, the former Chair of the SEC, had attempted to propose a rule that sought to address risks that MMFs posed to financial stability, but she was unable to convince a majority of the SEC commissioners to release the rule for comment.¹⁹³ Then-Treasury Secretary Timothy Geithner urged the FSOC to recommend to the SEC (pursuant to section 120 of Dodd–Frank) that such reform was necessary.¹⁹⁴ In November of 2012, the FSOC sought public comment on proposed recommendations to the SEC regarding three possible avenues of reform of MMFs, indicating that any of those reforms would help

the S. Comm. on Banking, Hous. & Urban Affairs, 113th Cong. 58 (2014) (written testimony of Robert C. Hockett, Professor, Cornell University).

¹⁹⁰ See *infra* notes 206–08 and accompanying text.

¹⁹¹ MURPHY & BERNIER, *supra* note 188, at 8.

¹⁹² Section 2(b) of now-defunct bill H.R. 4387, 113th Cong. (2014), sought to address this by giving each of the members of each agency with a multi-member commission a seat on the FSOC. Such a proposal, however, would most likely have rendered the FSOC unworkable, as it would have brought up to twenty more people to the table. Furthermore, because each agency would still have only had one vote, it would have required a second layer of consensus before the FSOC could take any action. See *id.*

¹⁹³ Jill E. Fisch, *The Broken Buck Stops Here: Embracing Sponsor Support in Money Market Fund Reform* 19–21 (Eur. Corp. Governance Inst. Working Paper Series in Law, Paper No. 275, 2014), <http://ssrn.com/abstract=2456255> [<http://perma.cc/5HBV-ES33>].

¹⁹⁴ *Id.* at 22.

mitigate the dangers that MMFs pose to financial stability.¹⁹⁵ In response, on June 5, 2013, the SEC promulgated a proposed rule that covered two potential avenues for reform, but each of these two avenues was on a much more limited scale than any of the FSOC's proposals.¹⁹⁶ The SEC's rule was adopted as final, with some amendments, on July 23, 2014.¹⁹⁷ Upon the release of these final rules, Treasury Secretary Lew, the current Treasury Secretary and chair of the FSOC, issued the somewhat cryptic statement that "[w]hile the SEC's reforms will require careful consideration and continued monitoring of their effectiveness in addressing risks to financial stability, the SEC's final rule is a significant step forward."¹⁹⁸ It remains to be seen whether the FSOC will take any further steps towards intervention.¹⁹⁹

¹⁹⁵ The options were:

1) [R]equiring MMFs to switch from a fixed to a floating NAV, 2) providing for a NAV capital buffer of up to 1%, supplied by a MMF sponsor together with a required minimum balance at risk for MMF investors, or 3) requiring a risk-based capital buffer of up to 3%, which could be combined with other risk-reducing measures.

Id. at 22–23.

¹⁹⁶ The Securities and Exchange Commission summarized the rule as follows:

The first alternative proposal would require money market funds to sell and redeem shares based on the current market-based value of the securities in their underlying portfolios, rounded to the fourth decimal place (*e.g.*, \$1.0000), *i.e.*, transact at a "floating" net asset value per share ("NAV"). The second alternative proposal would require money market funds to impose a liquidity fee (unless the fund's board determines that it is not in the best interest of the fund) if a fund's liquidity levels fell below a specified threshold and would permit the funds to suspend redemptions temporarily, *i.e.*, to "gate" the fund under the same circumstances.

Securities and Exchange Commission, Money Market Fund Reform; Amendments to Form PF, 78 Fed. Reg. 36,834 (proposed rule June 19, 2013). These more limited reforms have been critiqued by Sheila Bair as leaving "a number of money market funds, fund investors and the markets unprotected and at risk for destabilizing runs. It also creates real incentives for gaming and arbitrage." Nathaniel Popper, *S.E.C. Proposes Changes in Money Funds*, N.Y. TIMES: DEALBOOK (June 5, 2013, 1:07 PM), <http://dealbook.nytimes.com/2013/06/05/s-e-c-votes-to-take-next-step-on-money-market-funds/> [<http://perma.cc/Y8LW-BQQS>].

¹⁹⁷ The changes made to the proposed rules include the removal of exemptions for institutional non-government money market funds, as well as requirements for increased diversification of portfolios, enhanced stress testing, and increased transparency. Securities and Exchange Commission, Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47,736 (final rule Aug. 14, 2014) (to be codified at 17 C.F.R. pts. 230, 239, 270, 274, 279).

¹⁹⁸ Press Release, U.S. Dep't of the Treasury, Statement from Secretary Lew on the Final Money Market Mutual Fund Rule by the SEC (July 23, 2014), <http://www.treasury.gov/press-center/press-releases/Pages/j12583.aspx> [<http://perma.cc/K79D-2DQS>].

¹⁹⁹ The FSOC did indicate recently that it would look into the asset management industry more broadly, issuing a Notice Seeking Comment on Asset Management Products and Activities that stated that while the SEC "is undertaking several initiatives that would apply to investment companies and investment advisers regulated by the SEC and may

IV. CONCERNS REGARDING THE FSOC'S STRUCTURE AND MANDATE

Given the youth of the FSOC, any analysis of the FSOC's powers must by necessity be somewhat speculative. The interactions between the FSOC and the other financial regulatory agencies will, over time, add more color to our understanding of the FSOC. Even at the tender age of five, though, there are already reasons to be concerned about whether the FSOC is up to the vital challenge of promoting financial stability.

This Article has already made the case that financial regulation should be used to proactively pursue financial stability: the social costs of *ex post* responses to financial stability, and their incomplete efficacy in mitigating the economic fallout from financial crises, dictate that a financial stability regulator should not simply allow instability to develop, and then attempt to clean it up afterwards.²⁰⁰ However, when the economy is performing well and the financial system seems to be working smoothly, any regulatory intervention will likely be met with tepid public support and strident industry opposition.²⁰¹ Ideally, the FSOC would be structured in the way that best insulates it from these political realities, but as this Part will explore, there are flaws in the FSOC's structure and mandate that will likely increase its susceptibility to the cycle of political economy and to regulatory capture.

A. Problems with the FSOC's Structure

The FSOC is, at its core, a committee that is designed to work by “leverag[ing] the expertise that already exists at each [financial regulatory] agency,”²⁰² rather than performing extensive regulatory functions itself. As such, the efficacy of the FSOC will be stunted if these individual agencies do not contribute to the FSOC's financial stability mission. To put it another way, individual members of the FSOC will “come as advocates for their agency's positions and as defenders of their agency's turf and power,”²⁰³ and if the institutions that those members represent do not see financial stability as their end goal, a council of those members will not prioritize financial stability.²⁰⁴

address some of the risks described in this Notice[,] the SEC's initiatives are not specifically focused on financial stability.” Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77,488, 77,489 (Dec. 24, 2014) (footnote omitted).

²⁰⁰ See *supra* Part II.

²⁰¹ See *supra* text accompanying notes 82–84.

²⁰² *FSOC FAQs*, *supra* note 164.

²⁰³ Geoffrey P. Miller & Gerald Rosenfeld, *Intellectual Hazard: How Conceptual Biases in Complex Organizations Contributed to the Crisis of 2008*, 33 HARV. J.L. & PUB. POL'Y 807, 838–39 (2010).

²⁰⁴ Bar-Gill and Warren have noted that “[e]ffective regulation requires both authority and motivation.” Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 85 (2008). The agencies represented on the FSOC have historically had both authority and motivations other than financial stability: the OCC, the FDIC, and the

An international peer review of the United States' financial regulatory system released by the Financial Stability Board in August 2013 raised some of these issues, noting:

[T]he FSOC's decisions and actions reflect the views of a wide range of agencies with different mandates and interests. This might affect in some cases the FSOC's ability to take decisions in an effective and prompt manner, as the desire to reach a reasonable consensus among a large group of authorities might come at the expense of delivering clear and timely messages. . . .

. . . .
... Furthermore, the scope of the [FSOC's systemic] risk analysis currently is relatively narrow as it tends to reflect the sectoral perspectives of individual member agencies, rather than providing a system-wide view of interconnections and exposures to risks.²⁰⁵

This Part will explore in detail these, and other, problems that the FSOC's structure pose for financial stability regulation.

1. *Federal Reserve Dominance*

There is one member of the FSOC that is actively pursuing the goal of financial stability post-Crisis: although the Federal Reserve does not have an express statutory financial stability mandate,²⁰⁶ it takes the position that its "financial stability mandate is seen in the penumbra of the Federal Reserve

NCUA, for example, have tended to focus on banks and their safety and soundness, rather than on the stability of the financial system as a whole, or the macroeconomic effects of financial system failure. *Id.* at 90. Similarly, the SEC has traditionally focused on disclosure and investor protection, rather than on addressing structural issues within financial markets. Walter Werner, *The SEC as Market Regulator*, 70 VA. L. REV. 755, 755 (1984).

²⁰⁵ FIN. STABILITY BD., PEER REVIEW OF THE UNITED STATES 7 (Aug. 2013), http://www.financialstabilityboard.org/wp-content/uploads/r_130827.pdf [<http://perma.cc/6XPH-V3GJ>].

²⁰⁶ The Federal Reserve's founding legislation provides only that:

The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.

12 U.S.C. § 225(a) (2012).

Act, and that is legally sufficient.”²⁰⁷ Given the importance of financial stability, it is in many respects a good thing that a powerful body like the Federal Reserve has committed to preserving it.²⁰⁸ However, there is a concern that—despite the best of intentions and a commitment to a macroprudential approach to financial regulation²⁰⁹—the Federal Reserve’s efforts will be primarily informed by its historic concern with the safety and soundness of banking institutions,²¹⁰ and that it will therefore monitor threats to the financial system through bank-tinted lenses.²¹¹ Dodd–Frank itself encourages

²⁰⁷ Thomas C. Baxter stated:

The Federal Reserve’s financial stability mandate is seen in the penumbra of the Federal Reserve Act, and that is legally sufficient. . . . [L]eading economic thinkers would now say, and the financial crisis seems to offer us the perfect illustration, that price stability and maximum employment are possible only in a context of financial stability.

Thomas C. Baxter, Jr., Exec. Vice President & Gen. Counsel, Fed. Reserve Bank of N.Y., Remarks at the Future of Banking Regulation and Supervision in the EU Conference, Financial Stability: The Role of the Federal Reserve System (Nov. 15, 2013) (transcript available at <http://www.newyorkfed.org/newsevents/speeches/2013/bax131120.html> [<http://perma.cc/Y9FP-44T3>]).

²⁰⁸ It is, of course, possible that commitment to this unofficial mandate will wane over time. The Federal Reserve has often been critiqued for neglecting its statutorily mandated focus on maximum employment in favor of a single-minded focus on inflation. *The Federal Reserve: The Other Mandate*, *ECONOMIST* (Dec. 15, 2012), <http://www.economist.com/news/finance-and-economics/21568426-fed-specifies-unemployment-threshold-raising-rates-other-mandate> [<http://perma.cc/KMP6-E4BY>]. It is possible that the Federal Reserve’s enthusiasm for its implicit financial stability mandate could suffer the same fate.

²⁰⁹ Bernanke, *supra* note 5, at 5. For example, the Federal Reserve has created a new “Office of Financial Stability Policy and Research” to “identif[y] and analyze[] potential threats to financial stability; monitor[] financial markets, institutions, and structures; and assess[] and recommend[] policy alternatives to address these threats.” *The Economists: Office of Financial Stability Policy and Research*, BD. GOVERNORS FED. RES. SYS., <http://www.federalreserve.gov/econresdata/fsprstaff.htm> [<http://perma.cc/9EG9-BMLH>] (last updated Oct. 13, 2015).

²¹⁰ In addition to being the United States’ central bank, the Federal Reserve is (and has been since well before the Financial Crisis) the primary federal regulator for bank holding companies, and for state-chartered banks that are a member of the Federal Reserve System. CARNELL ET AL., *supra* note 77, at 61.

²¹¹ Taylor has argued that “the expertise necessary to regulate investment banks and insurance companies does not naturally reside in central banks.” Taylor, *supra* note 80, at 85. Providers of non-banking financial services who will be regulated by the Federal Reserve if designated as a SIFI pursuant to section 113 of Dodd–Frank have been particularly vociferous about their concerns that the Federal Reserve will take a “one-size-fits-all” banking-style approach to regulating these SIFIs. For example, the Chamber of Commerce has alleged that the FSOC is “over-populated with bank regulators and unduly influenced by that regulatory perspective.” Letter from David Hirshmann, President & CEO, Ctr. for Capital Mkts. Competitiveness, to Timothy Geithner, Sec’y, U.S. Dep’t of the Treasury 5 (Nov. 5, 2012), <http://www.centerforcapitalmarkets.com/wp-content/>

the Federal Reserve to respond to stability threats in a bank-centric way: section 115 encourages the Federal Reserve to apply heightened prudential requirements that are reminiscent of typical bank regulatory tools to the non-bank financial institutions that have been designated as SIFIs.²¹² However, as this section will explore, to the extent that the dominance of the Chair of the Federal Reserve within the FSOC shuts out other agencies' non-bank perspectives about how risks might build and be transmitted through the financial system (and how such risks should be addressed), such dominance is a cause for concern.

The organizational economics literature suggests that the best way to cultivate regulatory imagination about potential risks to stability is to synthesize inputs from regulators with different perspectives;²¹³ non-banking perspectives about threats to financial stability are unique and valuable contributions to financial stability regulation.²¹⁴ Financial institutions can certainly fail because of runs on their short-term funding, and if an institution is sufficiently large, then its failure can certainly have systemic ramifications. However, institutional failure may not always result from a funding run, and the failure of a number of smaller, non-bank institutions with correlated

uploads/2010/04/2012-11.5-MMF-Letter-to-Geithner.pdf [http://perma.cc/FX66-SSTS]. One of the key supervisory innovations following the Financial Crisis was the commencement of annual stress tests of large banks and designated SIFIs to determine whether “a covered company has the capital, on a total consolidated basis, necessary to absorb losses and continue its operations by maintaining ready access to funding, meeting its obligations to creditors and other counterparties, and continuing to serve as a credit intermediary under adverse economic and financial conditions.” Again, this focus on capital reflects typical bank regulatory notions about the importance of safety and soundness of institutions. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., DODD-FRANK ACT STRESS TEST 2013: SUPERVISORY STRESS TEST METHODOLOGY AND RESULTS (Mar. 2013), http://www.federalreserve.gov/newsevents/press/bcreg/dfast_2013_results_20130314.pdf [http://perma.cc/9JJS-NFE3].

²¹² As noted by William M. Butler:

Nonbank SIFIs, many for the first time, will be subject to oversight by the Federal Reserve and regulations that include capital requirements, leverage limits, liquidity requirements, resolution plans or living wills, credit exposure report requirements, concentration limits, contingent capital requirements, public disclosures, short-term debt limits, and other risk management requirements that the FSOC may recommend to the Federal Reserve.

Butler, *supra* note 174, at 668.

²¹³ In complex and rapidly changing environments, “a loosely knit, decentralized structure of multiple agencies is likely to be optimal,” because a decentralized structure allows for more and new ideas to be developed and shared. Luis Garicano & Richard A. Posner, *Intelligence Failures: An Organizational Economics Perspective*, 19 J. ECON. PERSP. 151, 157 (2005).

²¹⁴ It is beneficial for the FSOC to hear views about systemic risk from bodies other than the Federal Reserve. Erik F. Gerding, *The Subprime Crisis and the Link Between Consumer Financial Protection and Systemic Risk*, 4 FIU L. REV. 435, 461 (2009).

exposures can also precipitate instability.²¹⁵ Financial instability can arise even when institutions do not fail, perhaps because a problem with a widespread asset class has damaged confidence in a market such that capital intermediation is interrupted.²¹⁶ As such, financial stability regulators need to be concerned with much more than the safety and soundness of banks and large financial institutions: they need to be constantly probing interlinkages between different institutions and markets, and anticipating potential shocks that could ripple along those interlinkages.²¹⁷

To its credit, the FSOC has been exploring novel ways in which insurance firms can pose systemic risk, not restricting its analysis to large insurers' dependence on short-term funding (although concerns about such reliance have indeed loomed large in the FSOC's decisions to designate AIG, Prudential, and MetLife as SIFIs).²¹⁸ For example, the FSOC has raised concerns about the dependence of other financial firms on insurers for coverage, and the consequences for those other financial firms if such coverage were to become unavailable as a result of "a spike in claims due to correlated risks, other types of actuarial miscalculations or under-reserving, undercapitalization, or portfolio losses."²¹⁹ However, McCoy notes that to date, the FSOC has not been very clear in articulating exactly what types of insurance coverage are susceptible to such an analysis, and what other financial firms might be significantly harmed should coverage dry up.²²⁰ A close familiarity with the insurance industry is vital in fully developing such theories. Additionally, insurance regulators have the best information about the investments made by insurance companies (particularly in corporate bond markets), and an understanding of this demand can be integral to understanding the development of bubbles in such markets.²²¹ Insurance experts must therefore be heard on matters of financial stability.

²¹⁵ "[W]e should note, the weakest link in the financial stability chain might be *small*, rather than large, financial intermediaries." Eric S. Rosengren, President & CEO, Fed. Reserve Bank of Bos., Keynote Remarks at the Stanford Finance Forum, Defining Financial Stability, and Some Policy Implications of Applying the Definition, 9 (June 3, 2011) (transcript available at <http://www.bostonfed.org/news/speeches/rosengren/2011/060311/060311.pdf> [<http://perma.cc/NJL9-TUD6>]).

²¹⁶ *Id.* at 4.

²¹⁷ The shock that precipitates financial instability might not even come from within the financial system itself: as the FSOC recently identified, it could be an act of cyberterrorism targeting financial system infrastructure. FIN. STABILITY OVERSIGHT COUNCIL, 2011 ANNUAL REPORT 1, 5 (2011) [FSOC REPORT].

²¹⁸ For a discussion of the FSOC's concerns regarding the susceptibility of AIG, Prudential, and MetLife to runs, see Patricia A. McCoy, *Systemic Risk Oversight and the Shifting Balance of State and Federal Authority over Insurance*, 5 U.C. IRVINE L. REV. (forthcoming 2015) (manuscript at 42–48), <http://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1938&context=lsfp> [<http://perma.cc/N4HC-UD3E>].

²¹⁹ *Id.* (manuscript at 66).

²²⁰ *Id.* (manuscript at 65–67).

²²¹ Schwarcz & Schwarcz, *supra* note 76, at 1589–99.

Similarly, as the “cop on the beat” taking complaints regarding consumer financial products, the CFPB is likely to be the first agency to see evidence of a bubble in a particular class of consumer financial products (including products that are offered by institutions that are not otherwise regulated by any financial regulatory agency),²²² and so its input is key to the financial stability project. Patterns of consumer complaints with respect to a particular financial institution can also be an early warning of problems with that institution²²³—other indicators of trouble (like the regulatory capital standards that are the focus of bank-centric regulation) tend to lag behind.²²⁴ Finally, consumer protection regulation can promote financial stability by preventing or mitigating negative market distortions that result from imperfectly informed (and bubble-creating) consumer choices.²²⁵ The CFPB’s input is therefore also integral to financial stability regulation.

The SEC’s expertise with regard to securities markets is also invaluable. For example, a number of highly publicized computer glitches in recent years have focused regulatory scrutiny on high frequency trading, including the Flash Crash on May 6, 2010,²²⁶ and the losses suffered by Knight Capital on August 1, 2012.²²⁷ While neither of these market disruptions had a broad systemic impact, many are concerned that similar incidents could precipitate a full-blown crisis in the future.²²⁸ The SEC is also likely to know more than the

²²² “The jurisdiction of the Bureau . . . extends to the world of payday lenders, credit counselors and pawn shops.” Donald N. Lamson & Hilary Allen, *Consumer Financial Protection: It’s a Smaller World After All*, 96 BNA’S BANKING REP. 552 (Mar. 22, 2011).

²²³ See generally Daniel Schwarcz, *Redesigning Consumer Dispute Resolution: A Case Study of the British and American Approaches to Insurance Claims Conflict*, 83 TUL. L. REV. 735 (2009).

²²⁴ ANAT ADMATI & MARTIN HELLWIG, *THE BANKERS’ NEW CLOTHES: WHAT’S WRONG WITH BANKING AND WHAT TO DO ABOUT IT* 190 (2014).

²²⁵ Bar-Gill & Warren, *supra* note 204, at 58–59. It is also worth exploring whether the CFPB could or should engage in class-action-like contract modification of oppressive contracts that are causing the build-up of systemic risk. In this way, the CFPB could act as a “safety valve,” releasing risk from the system. For a discussion of the need for such safety valves, see Pistor, *supra* note 94, at 329.

²²⁶ U.S. COMMODITY FUTURES TRADING COMM’N & U.S. SEC. & EXCH. COMM’N, *FINDINGS REGARDING THE MARKET EVENTS OF MAY 6, 2010: REPORT OF THE STAFFS OF THE CFTC AND SEC TO THE JOINT ADVISORY COMMITTEE ON EMERGING REGULATORY ISSUES* 2 (Sept. 2010), <https://www.sec.gov/news/studies/2010/marketevents-report.pdf> [<https://perma.cc/9RGN-AJN5>].

²²⁷ Nathaniel Popper, *Knight Capital Says Trading Glitch Cost It \$440 Million*, N.Y. TIMES: DEALBOOK (Aug. 2, 2012, 9:07 AM), http://dealbook.nytimes.com/2012/08/02/knight-capital-says-trading-mishap-cost-it-440-million/?_r=1 [<http://perma.cc/3ND8-HBG6>].

²²⁸ Tom C.W. Lin, *The New Investor*, 60 UCLA L. REV. 678, 706 (2013).

[A]lgorithmic trades tend to be correlated, suggesting that the HFT strategies used in the market are not as diverse as those used by human traders. In this context, shocks hitting the small number of very active algorithmic traders might affect the entire market. And, because high frequency trading firms are often very lightly capitalised, this could generate failures. Handling the corresponding counterparty risk could be

Federal Reserve about the various brokers or dealers that act as market makers for securities.²²⁹ Because these market makers “stand[] ready to buy and sell a particular stock on a regular and continuous basis at a publicly quoted price,”²³⁰ if a number of market makers are compromised, then liquidity within the financial system might be seriously disrupted.²³¹ A focus on the workings of the securities markets is thus necessary as part of the financial stability project, even if none of the players therein are deemed large enough to be a problem from a “too big to fail” perspective.

The foregoing does not purport in any way to be an exhaustive discussion of the sources of systemic risk in our financial system. However, the examples given here are sufficient to illustrate that a limited focus on the solvency of banks and other large financial institutions runs the risk of neglecting important systemic risks, particularly those being created by the herd behavior of smaller institutions.²³² As such, the efficacy of financial stability regulation is likely to be stunted unless all of the financial regulatory agencies—not just the Federal Reserve—commit to the task of identifying and addressing threats to financial stability. It is also worth noting that if all of the regulatory agencies were to rise to this challenge, then supervision and monitoring of non-bank institutions’ destabilizing behaviors could be effected without designating institutions as SIFIs subject to the Federal Reserve’s jurisdiction—potentially neutralizing the politically-charged issue of SIFI designation.²³³

2. Treasury Dominance

The dominance of the Treasury Secretary within the FSOC raises more concerns than the prominence of the Federal Reserve. In addition to being the Chairperson of the FSOC, the Treasury Secretary has perhaps the greatest powers of any member of the FSOC (including the power to set the FSOC’s agenda, and to veto any designation of a financial institution as subject to heightened prudential supervision).²³⁴ Furthermore, the Treasury Department

daunting, given that HFT firms turn over their positions many times a day, while clearing systems operate at a much lower frequency. Combined, these elements could generate systemic market disruptions.

Bruno Biais & Paul Woolley, *The Flip Side: High Frequency Trading*, FIN. WORLD, Feb. 2012, at 34, 35, <http://www.lse.ac.uk/fing/researchProgrammes/paulWoolleyCentre/pdf/FinancialWorldArticle.pdf> [<http://perma.cc/6TES-XPCJ>].

²²⁹ Brokers and dealers are regulated by the SEC pursuant to section 15 of the Securities Exchange Act of 1934. Securities Exchange Act of 1934 § 15, 15 U.S.C. § 78o (2012).

²³⁰ *Market Maker*, U.S. SEC. & EXCHANGE COMM’N, <http://www.sec.gov/answers/mktmaker.htm> [<http://perma.cc/4TUX-V27H>] (last modified Mar. 17, 2000).

²³¹ Rosengren, *supra* note 215, at 13.

²³² Stiglitz, *supra* note 97, at 17.

²³³ See *supra* note 8 and accompanying text.

²³⁴ See *supra* text accompanying notes 186–88. The Treasury Secretary is also responsible for appointing the person who controls the oral hearing proceedings for a

provides the FSOC with much of its administrative support,²³⁵ and also houses and exerts control over the OFR²³⁶ (which is a primary source of the FSOC's data and analysis regarding emerging threats to financial stability).²³⁷ This Part will explore how placement of a political figure like the Treasury Secretary at the apex of the FSOC may jeopardize the FSOC's ability to fulfill its financial stability mandate.

As this Article has explored, political economy is one of the greatest difficulties that *ex ante* financial stability regulation faces.²³⁸ The vagaries of politics have long been thought to be inimical to good financial regulation; instead, financial regulatory agency independence has traditionally been favored because it allows for high technical expertise, policy stability and uniformity, and also a longer term perspective²³⁹ (the latter of which is particularly essential to financial stability regulation).²⁴⁰ However, given that the Treasury Secretary is a presidential cabinet appointee removable at will, he or she is less insulated from the political whims of the executive than any of the other members of the FSOC,²⁴¹ and is more likely to be susceptible to "timing considerations, adverse public opinion, and interest group pressures."²⁴² Thus, by placing the Treasury Secretary at the pinnacle of the

financial institution seeking to dispute its designation as a SIFI. Butler, *supra* note 174, at 678.

²³⁵ The GAO reported that:

[The FSOC] has established a dedicated policy office within Treasury's Office of Domestic Finance, led by a Deputy Assistant Secretary, which functions as the FSOC Secretariat. Among other duties, the policy office works with staff of other FSOC members to support FSOC in its day-to-day operations by helping to draft rules, studies, and reports and prepare and circulate relevant materials to agency members prior to council meetings. The office also serves as a mechanism to bring issues to the council quickly.

GAO-12-886, *supra* note 170, at 12.

²³⁶ The OFR must consult with the Secretary of the Treasury in connection with any rulemaking, the establishment of its budget, and personnel hiring and compensation. Jennifer S. Taub, *Great Expectations for the Office of Financial Research*, in *WILL IT WORK? HOW WILL WE KNOW? THE FUTURE OF FINANCIAL REFORM* 23, 24–25 (Michael Konczal ed., Roosevelt Institute 2010), http://www.rooseveltinstitute.org/sites/all/files/Will%20It%20Work%20How%20Will%20We%20Know_0.pdf [<http://perma.cc/BN2V-ARMP>].

²³⁷ Dodd–Frank Act § 152(a), 12 U.S.C. § 5342 (2012).

²³⁸ See *supra* text accompanying notes 81–96.

²³⁹ Gadinis, *supra* note 176, at 340.

²⁴⁰ Allen, *supra* note 31, at 206.

²⁴¹ Gadinis, *supra* note 176, at 332; see also DAVID SKEEL, *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD–FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* 12 (2011) ("Because the Treasury secretary is directly responsible to the President, he is the least independent, and the most political, of the financial regulators. Yet the Treasury secretary is given leadership responsibility on the new Financial Stability Oversight Council and in other areas.").

²⁴² Gadinis, *supra* note 176, at 388.

only United States body expressly charged with addressing threats to financial stability, Dodd–Frank has to some extent reversed the guiding principle of independence and increased the susceptibility of the FSOC, and financial stability regulation, to the whims of political economy.²⁴³

In boom times, it may be too much to expect that a Treasury-led FSOC will aggressively pursue financial stability (for example, by recommending that individual agencies apply heightened safeguards to profitable activities pursuant to section 120, or by designating profitable institutions as subject to enhanced regulatory scrutiny pursuant to section 113). By virtue of its control over the FSOC’s agenda, the Treasury Secretary has the power to prevent the FSOC from even discussing potential sources of systemic risk that are politically “too hot to handle.” It has also been argued that the Treasury’s control over the OFR could ensure that the OFR’s information gathering and analysis functions reflect the politically expedient policy of “defend[ing] existing practices of the financial sector and provid[ing] generous support when important firms need assistance.”²⁴⁴ Furthermore, while this Article has largely focused on the difficulties of regulating for financial stability when the financial system is (or appears to be) performing well, the increased politicization of financial stability regulation can also be problematic once a financial crisis has developed. As Gadinis notes, “there is a significant risk that voters, in the midst of uncertainty and widespread skepticism, might press politicians to refrain from intervening in the financial industry when intervening would be otherwise appropriate.”²⁴⁵ As such, the Treasury Secretary’s role in the FSOC is potentially problematic in bad times as well as good.

3. *Broader Coordination Challenges*

The dominance of the Treasury and the Federal Reserve within the FSOC is thus undesirable in many respects. Unfortunately, the heads of the other financial regulatory agencies are unlikely to serve as a counterbalance within the FSOC. It is difficult for the various financial regulatory agencies, all of which have pre-existing regulatory priorities and identities that potentially conflict with a focus on financial stability matters, to coordinate on financial stability matters.²⁴⁶ Going forward, these agencies are even less likely to focus

²⁴³ Barkow notes that when a politicized executive agency is hierarchically superior to, and able to direct, independent regulatory agencies, then the independence of those agencies is rendered meaningless. Rachel E. Barkow, *Insulating Agencies: Avoiding Capture Through Institutional Design*, 89 TEX. L. REV. 15, 51 (2010).

²⁴⁴ Johnson, *supra* note 172.

²⁴⁵ Gadinis, *supra* note 176, at 385.

²⁴⁶ According to the GAO:

[The] FSOC’s effectiveness [in providing for a more comprehensive view of threats to U.S. financial stability] hinges to a large extent on collaboration among its many members, almost all of whom come from state and federal agencies with their own

on financial stability issues as the economy improves, and the importance of financial stability regulation fades from public attention. Furthermore, the very existence of the FSOC may disincentivize such focus: the FSOC may provide a pretext for the other financial regulatory agencies to shirk any responsibility they might otherwise have felt to take action in the face of financial instability.²⁴⁷

To be clear, the other financial regulatory agencies do not have any express responsibilities with respect to financial stability. However, the statutory requirement in section 112(b) of Dodd–Frank that each voting member of the FSOC submit an annual statement to Congress regarding extant threats to financial stability gives each such member (and their agency) an implicit direction to monitor such threats.²⁴⁸ Sections 113 and 804 implicitly direct each member to keep an eye on SIFIs and market utilities, in order to determine whether they should be designated as requiring heightened supervision.²⁴⁹ Similarly, section 120 implicitly directs each member to monitor potentially problematic financial activities or practices, to enable them to determine whether the FSOC should make a recommendation to apply new or heightened standards or safeguards to such activities or practices.²⁵⁰ Given that none of these obligations are particularly firm, though, there is a real possibility that the FSOC’s members will seek to shirk such responsibilities—particularly when taking action is too challenging or politically unpalatable—and attribute blame for any notable failures to the FSOC as a whole.²⁵¹

specific statutory missions. In testifying on the coordination of Dodd–Frank rulemakings assigned to specific FSOC members, before the U.S. House Financial Services Committee in October 2011, the chairperson of FSOC recognized this challenge. He noted that the coordination challenge in the rulemaking process was hard because the Dodd–Frank Act left in place a financial system with a complicated set of independent agencies with overlapping jurisdictions and different responsibilities.

GAO-12-886, *supra* note 170, at 8.

²⁴⁷ Regarding the risk of shirking, see Barkow, *supra* note 243, at 56 (“It is all too easy for agencies to point fingers at each other with no one ultimately held accountable.”).

²⁴⁸ Dodd–Frank Act § 112(b), 12 U.S.C. § 5322 (2012).

²⁴⁹ *See Id.* §§ 113, 804.

²⁵⁰ *See Id.* § 120.

²⁵¹ The beginnings of such a dynamic can perhaps be inferred from a recent speech by SEC Chair Mary Jo White, which included the text:

Truly tackling systemic risk in any area, obviously, demands a broader program than one agency can execute. Systemic risks cannot be addressed alone—they are, after all, “systemic.” Risks that could cascade through our financial system could have an impact on a range of market participants, many of which we do not oversee. The Financial Stability Oversight Council (FSOC) is an important forum for studying and identifying systemic risks across different markets and market participants. The market perspective that the SEC brings is an essential component of FSOC’s efforts.

The potential for the FSOC to serve as a pretext for shirking has not yet been explored in the financial regulatory literature, but there is a burgeoning administrative law literature on interagency interaction that may assist here. Freeman and Rossi, for example, have considered whether “where responsibility is shared, agencies might be more inclined to shirk their duties.”²⁵² They conclude that such shirking is, in fact, often prevented by coordination mechanisms that facilitate interagency monitoring.²⁵³ The coordination mechanisms that Freeman and Rossi have in mind include mandated interagency consultation,²⁵⁴ which is one of the key functions of the FSOC’s mandated quarterly meetings.²⁵⁵ However, there are a number of reasons to be less than sanguine regarding the prospect of the FSOC as a facilitator of interagency monitoring in the financial stability context.²⁵⁶

First, any requirement for the FSOC’s members (and their agencies) to monitor threats to financial stability on an ongoing basis is, at best, implicit.²⁵⁷ It is difficult for any member of the FSOC (or the public) to hold another member accountable for shirking such nebulous obligations. Although the FSOC could use its recommendation power under section 120 of the Dodd–Frank Act to bring a shirking agency into line, because it has limited resources of its own, the FSOC *qua* FSOC is in no position to monitor financial regulatory agencies.²⁵⁸ Monitoring must therefore come from the FSOC’s members and their agencies, and given that those agencies have at best implicit financial stability obligations themselves, they are not required to focus on potentially destabilizing activities of other agencies. The only players likely to take action in this context are the Federal Reserve, which views itself as having a financial stability mandate, and the Treasury, if the political winds

And FSOC’s current review of the potential risks to the stability of U.S. financial system of asset managers is a complement to the work we are now undertaking.

Mary Jo White, Chair, Sec. & Exch. Comm’n, Speech at the New York Times DealBook Opportunities for Tomorrow Conference, Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry (Dec. 11, 2014) (transcript available at <http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VKy7Slu61UQ> [<http://perma.cc/E6TH-D4EE>]). White gave this speech the week before the FSOC published its Notice Seeking Comment on Asset Management Products and Activities, *supra* note 199, perhaps suggesting a pre-agreed division of labor whereby responsibility for systemic risk would fall on the FSOC rather than the SEC.

²⁵² Freeman & Rossi, *supra* note 177, at 1187.

²⁵³ *Id.* at 1188.

²⁵⁴ *Id.* at 1157, 1160.

²⁵⁵ See FSOC REPORT, *supra* note 217, at 129.

²⁵⁶ Ongoing cooperation and commitment with respect to financial stability regulation should be distinguished from instances of joint-rulemaking required by Dodd–Frank, where it is very clear that particular agencies are responsible for making the rules, and thus it is very clear when shirking has occurred. *Id.* at 1191.

²⁵⁷ See *supra* notes 248–51.

²⁵⁸ This is in contrast to situations where there is a true lead agency that is driving the process and can be held accountable. *Id.* at 1192.

are blowing against a particular financial agency, product, or activity. As this Part has already established, it is less than ideal that interagency monitoring always be informed by such a politicized or bank-centric perspective.

It is possible that, even in the absence of any statutory obligation for the financial regulatory agencies to pursue financial stability, each of those agencies may be incentivized to monitor each other's activities because of the fear of the reputational harm they will suffer if a financial crisis occurs: Marisam has argued that interagency monitoring will prevent shirking when the activities of one agency have negative externalities for other agencies with overlapping competencies.²⁵⁹ However, Marisam acknowledges that the risk of shirking rises when various agencies are responsible for the same task, instead of being responsible for different information or subtasks, because it is easier to spread blame for any regulatory failures.²⁶⁰ Financial crises are such complex events that it is difficult to pinpoint the exact cause of such crises,²⁶¹ and thus to point fingers at particular regulatory failures. Furthermore, there is a lot of overlap in financial regulatory agency competencies—the OCC, the FDIC, and the Federal Reserve cover very similar territory when regulating banks and bank holding companies,²⁶² as do the SEC and the CFTC when they are regulating derivatives.²⁶³ Given these circumstances, it is perhaps not surprising that the history of financial agency interactions suggests a tendency for agencies to shirk regulatory responsibilities that are unpopular with the regulated industry. Banking regulators' approach to consumer financial protection prior to the Financial Crisis is illustrative of this tendency: as one author noted, "because consumer protection has been everyone's responsibility, it has been no one's responsibility, and accountability and performance have suffered therewith."²⁶⁴ If the FSOC is viewed as having sole responsibility for financial stability, and if the FSOC is not sufficiently robust or has insufficient resources to actually pursue those financial stability objectives, financial stability may also become the responsibility of no one (or no one other than the Federal Reserve and Treasury).

To date, the FSOC's response to its coordination problems has largely consisted of forming committees, intended to "support collaboration among FSOC members both on a formal and informal basis."²⁶⁵ These committees

²⁵⁹ Jason Marisam, *Interagency Administration*, 45 ARIZ. ST. L.J. 183, 214–15 (2013).

²⁶⁰ *Id.* at 215.

²⁶¹ Allen, *supra* note 122, at 893.

²⁶² CARNELL ET AL., *supra* note 77, at 443.

²⁶³ See Dodd–Frank Act tit. 7, 15 U.S.C. § 8301 (2012).

²⁶⁴ *Enhanced Consumer Financial Protection After the Financial Crisis: Hearing on Examining the Impact of the Financial Crisis on Consumers and How the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 Will Enhance Consumer Financial Protection Before the S. Comm. on Banking, Hous., and Urban Affairs*, 112th Cong. 106 (2011) (written testimony of Adam J. Levitin, Professor of Law, Georgetown University Law Center) [hereinafter Levitin Testimony].

²⁶⁵ Clowers Statement, *supra* note 161, at 14.

include a Systemic Risk Committee, a Designation of Non-bank Financial Companies Committee, a Designation of Financial Market Utilities Committee, and a Heightened Prudential Standards Committee.²⁶⁶ Membership of these committees may, to some extent, serve to train individual agency focus on financial stability matters. However, because the FSOC “does not keep detailed records of deliberations or discussions that take place at the council’s meetings or at the committee level,”²⁶⁷ there would be little evidence available from the committee’s deliberations to hold any agency accountable for shirking its implicit obligations. Shirking could perhaps be reduced by requiring more transparency regarding the deliberations of the FSOC and its committees (although transparency with regard to financial stability deliberations is fraught for other reasons),²⁶⁸ but I suspect that this, and other process-oriented reforms suggested by the Government Accountability Office (GAO),²⁶⁹ would have a limited impact on the commitment of the FSOC’s member agencies to financial stability concerns. Similarly, although the FSOC is overseen by a Council of Inspectors General on Financial Oversight (CIGFO), to date this council has kept a relatively low profile and focused on the FSOC’s compliance with discrete processes set out in Dodd–Frank.²⁷⁰ Again, I suspect that the CIGFO will have a limited impact on the commitment of the FSOC’s member agencies to financial stability concerns.

Other reform options have been suggested by Representative Scott Garrett (R-NJ), and Senator David Vitter (R-LA), both of whom have introduced bills proposing to restructure the FSOC.²⁷¹ Garrett’s bill died with the end of the 113th Congress in January 2015, but if it had been enacted, section 2(b) thereof would have made every member of the Federal Reserve Board of Governors, the SEC, the CFTC, the FDIC, and the National Credit Union

²⁶⁶ There is also a Deputies Committee, an Orderly Liquidation Committee, and a Data Committee. *Id.* at 3.

²⁶⁷ *Id.* at 9.

²⁶⁸ In its transparency policy, the FSOC notes that:

The Council will open its meetings to the public whenever possible. At the same time, the central mission of the Council is to monitor systemic and emerging threats. This will require discussion of supervisory and other market-sensitive data, including information about individual firms, transactions, and markets that may only be obtained if maintained on a confidential basis. Protection of this information will be necessary in order to prevent destabilizing market speculation that could occur if that information were to be disclosed.

FIN. STABILITY OVERSIGHT COUNCIL, TRANSPARENCY POLICY FOR THE FINANCIAL STABILITY OVERSIGHT COUNCIL 1 (2014), <http://www.treasury.gov/initiatives/Documents/FSOCtransparencypolicy.pdf> [<http://perma.cc/6ZC9-CT4B>].

²⁶⁹ The GAO has recommended a number of other process-oriented reforms to the FSOC, as outlined in Clowers Statement, *supra* note 161, at 8.

²⁷⁰ COUNCIL OF INSPECTORS GEN. ON FIN. OVERSIGHT, ANNUAL REPORT 1–3 (July 2014), <http://www.treasury.gov/about/organizational-structure/ig/Documents/CIGFO%20ANNUAL%20REPORT%202014%20FINAL.pdf> [<http://perma.cc/LK4P-SGVK>].

²⁷¹ H.R. 4387, 113th Cong. (2014).

Administration (NCUA) a member of the FSOC—bringing twenty more people to the table at any FSOC meeting on financial stability matters (but still giving each agency only one vote, requiring each multi-party commission to agree to take action before the FSOC as a whole could do so).²⁷² Furthermore, section 2(c) of the bill would have required that:

[A]t any FSOC meeting . . . [e]ven if the meeting was being held in private, it could be attended by up to 83 legislators—the 61 members of the House Financial Services Committee and the 22 members of the Senate Banking Committee. If staff members from the FSOC member agencies assembled for a meeting, the Financial Services and Banking Committee staffs would also have to be invited.²⁷³

The combined effect of these provisions would have been to increase the susceptibility of the FSOC to political pressure, and to make the FSOC more cumbersome and stymie its ability to act.²⁷⁴

Vitter's bill, titled the "Terminating the Expansion of Too-Big-To-Fail Act of 2015"²⁷⁵ was introduced in January of 2015. The majority of Vitter's bill is focused on repealing the FSOC's designation power.²⁷⁶ However, several provisions of Vitter's bill reach beyond the designation process and have the potential to limit the FSOC's ability to discharge its financial stability mandate more generally. These include: (i) the repeal of section 120(d)(3) of Dodd–Frank, which directs the FSOC to consider legislation regulating non-bank financial institutions that have no primary federal regulator, but pose risks to financial stability;²⁷⁷ (ii) the repeal of sections 216 and 217 of Dodd–Frank, which require studies relating to domestic and international procedures for the resolution of non-bank financial institutions;²⁷⁸ and (iii) the repeal of the entire Title VIII of Dodd–Frank, which relates to regulation of payment and clearing and settlement systems (sometimes referred to as the "plumbing" of the financial system).²⁷⁹ As Part V will explore in more detail, reform of the FSOC needs to move in the opposite direction to the Garrett and Vitter Bills.

²⁷² See *id.* § 2(b).

²⁷³ Norris, *supra* note 8.

²⁷⁴ "That would seem to be a recipe to hamstring FSOC, but members of the committee see it as a matter of openness and fairness." *Id.* Similarly, Lubben has noted that the bill "purports to be aimed at increasing transparency at the council. But its real aim is clearly to muck up the workings of the council." Stephen J. Lubben, *A Legislative Assault on the Financial Stability Oversight Council*, N.Y. TIMES: DEALBOOK (June 10, 2014, 2:18 PM), http://dealbook.nytimes.com/2014/06/10/a-legislative-assault-on-the-financial-stability-oversight-council/?_r=1 [<http://perma.cc/68HU-9HA2>].

²⁷⁵ S. Res. 107, 114th Cong. § 1 (2015).

²⁷⁶ *Id.* § 2.

²⁷⁷ *Id.* § 2(a)(8)(B).

²⁷⁸ *Id.* § 2(b).

²⁷⁹ *Id.* § 3.

B. Problems with the FSOC's Mandate

The preceding Part explored why the FSOC, as a committee of regulators dominated by the Federal Reserve and the Secretary of the Treasury, is not optimally structured to address threats to financial stability. As this Part will explore, the FSOC's statutory financial stability mandate is also less than ideal.

The FSOC's mandate is set out in section 112(a)(1) of Dodd–Frank, and reads as follows:

The purposes of the Council are—

(A) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;

(B) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and

(C) to respond to emerging threats to the stability of the United States financial system.²⁸⁰

The most obvious problem with this mandate is the inclusion of section 112(a)(1)(B), which seems to be at cross-purposes with the rest of the mandate. Although one of the stated purposes of the Dodd–Frank legislation is to end expectations of emergency governmental support for the financial industry, the general consensus is that these expectations of intervention—and the moral hazard they create—persist post-Dodd–Frank.²⁸¹ While it is preferable to proactively address potential financial stability concerns, emergency measures may well be required if such proactive regulation fails.²⁸² As such, well-designed *ex post* safety nets should be formalized in advance to allow the FSOC to carry out its mandated purpose in section 112(a)(1)(C): to “[r]espond to emerging threats to the stability of the United States financial system.”²⁸³ The ban in section 112(a)(1)(B) on formalizing any kind of safety net in advance will only ensure that if intervention does become necessary

²⁸⁰ Dodd–Frank Act § 112(a)(1), 12 U.S.C. § 5322 (2012).

²⁸¹ See, e.g., JOHNSON & KWAK, *supra* note 64, at 207; Cheryl D. Block, *Measuring the True Cost of Government Bailout*, 88 WASH. U. L. REV. 149, 224 (2010); Levitin, *supra* note 81, at 513.

²⁸² See *supra* text accompanying note 98. For a thoughtful exploration of structuring such *ex post* responses, see Anabtawi & Schwarcz, *supra* note 72, at 102–22.

²⁸³ Dodd–Frank Act § 112(a)(1)(C).

(and if a crisis is large enough, there will most likely be sufficient political pressure to intervene), it will be *ad hoc* in nature.²⁸⁴

A more fundamental (but less obvious) problem with the FSOC's mandate is the lack of clarity regarding the concepts of "financial stability" and "stability of the United States financial system." These concepts are clearly central to subsections 112(a)(1)(A) and (C),²⁸⁵ but Dodd–Frank does not provide any definition of "financial stability." I have argued elsewhere that financial stability means both the absence of financial crisis *and* the financial system's smooth functioning and ability to absorb (rather than amplify) shocks such as tail-risks,²⁸⁶ and the FSOC seems to accept this approach. In its 2011 Annual Report, the FSOC stated that "[a] stable financial system should not be the source of, nor amplify the impact of, shocks."²⁸⁷ However, as this Part will explore, an *ad hoc* description buried in the FSOC's annual report does not carry sufficient weight to focus regulatory attention on financial stability issues in boom times. Furthermore, this informal description does not address the normative question of why financial stability should be a policy goal in the first place.

If financial instability only affected the profitability and solvency of financial institutions themselves, then there would be no need for financial stability regulation, nor to intervene when financial institutions or markets failed.²⁸⁸ Unfortunately, because of "the close linkages between financial stability and the health of the real economy,"²⁸⁹ "a distinguishing feature of . . . financial instability is that innocent bystanders get hurt."²⁹⁰ As such, the FSOC's mandate should reflect that the financial system is a means to an end (i.e., it exists to facilitate payments and the distribution of capital, as well as to manage risk, so that the economy beyond the financial system can grow), rather than an end in itself. However, the text of Dodd–Frank does not clearly

²⁸⁴ *Id.* § 112(a)(1)(B).

²⁸⁵ *Id.* § 112(a)(1)(A), (C).

²⁸⁶ Allen, *supra* note 53, at 943–44.

²⁸⁷ See FSOC REPORT, *supra* note 217, at 3. It should be noted that the FSOC is sometimes inconsistent in its approach to "financial stability." In the FSOC's rules implementing section 113 of Dodd–Frank with respect to the supervision and regulation of non-bank financial companies, the FSOC stated that it "will consider a 'threat to the financial stability of the United States' to exist if there would be an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy." 12 C.F.R. § 1310.23 (2013). Admittedly, this definition applies only in a particular context (i.e., when determining whether non-bank financial companies should be subjected to heightened prudential regulation), but it is inconsistent with the FSOC's general approach articulated in its Annual Report because this latter definition focuses exclusively on the absence of crisis, and does not incorporate concepts of resilience or robustness. See FSOC REPORT, *supra* note 217, at ii–iii.

²⁸⁸ As the FSOC noted in its 2011 Annual Report, it is concerned with "the stability of the financial system as a whole, as opposed to the risk facing individual financial institutions or market participants." See FSOC REPORT, *supra* note 217, at 132.

²⁸⁹ Crockett, *supra* note 81, at 8.

²⁹⁰ Allen & Wood, *supra* note 18, at 160.

convey this message.²⁹¹ In particular, because the FSOC's statutory mandate expressly references financial institutions and the financial system without mentioning externalities, the broader economy, or macroeconomic growth, it could be read as implying that the FSOC should concern itself with the financial sector *qua* financial sector, rather than the consequences of financial system failure for society at large.

To be clear, there is nothing in the FSOC's mandate that expressly *prevents* it from approaching financial stability as a means to promoting broader economic prosperity. The problem is that there is nothing in the FSOC's mandate that *requires* it to take this approach to financial stability either. Regulators often lack public backing for their endeavors to promote public goods like financial stability,²⁹² and without a constant statutory reminder of what financial stability really is and whom it concerns, the goal of financial stability can lose salience and legitimacy in times when the financial system seems to be functioning normally.²⁹³ Furthermore, as Dodd–Frank is currently worded, there would be no statutory grounds for holding the FSOC accountable if it follows the path of least resistance and ignores externalities, focusing instead on the financial sector as an end in itself. Given that many financial regulators have a dubious pre-Crisis track record of prioritizing industry profitability (in the guise of efficiency) over broader public welfare concerns,²⁹⁴ it seems particularly remiss that the FSOC's statutory mandate does not emphasize the importance of avoiding the externalities of financial instability that affect those beyond financial institutions (and beyond their shareholders, creditors and counterparties).

Instead, there are several legislative directions in Dodd–Frank that the FSOC focus on efficiency and market discipline,²⁹⁵ which could prove particularly useful to industry participants seeking to challenge financial stability regulation. Judicial review is intended to ensure that the FSOC's actions accord with its statutory mandate and powers,²⁹⁶ but in the absence of

²⁹¹ Dodd–Frank has been criticized for failing to “articulate the principle for balancing the public interest in preserving financial stability and limiting systemic risk against the private interests of financial market participants in pursuing economic gain.” Saule T. Omarova, *Bankers, Bureaucrats, and Guardians: Towards Tripartism in Financial Services Regulation*, 37 J. CORP. L. 621, 634 (2012).

²⁹² Evan J. Criddle, *Fiduciary Administration: Rethinking Popular Representation in Agency Rulemaking*, 88 TEX. L. REV. 441, 473 (2010); Short, *supra* note 83, at 680.

²⁹³ Brett McDonnell, *Dampening Financial Regulatory Cycles*, 65 FLA. L. REV. 1597, 1605 (2013).

²⁹⁴ Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving in to Wall Street*, 81 U. CIN. L. REV. 1283, 1328–59 (2013).

²⁹⁵ For example, section 112(a)(2)(N) of Dodd–Frank directs the FSOC to annually report to and testify before Congress regarding “recommendations (I) to enhance the integrity, efficiency, competitiveness, and stability of United States financial markets; (II) to promote market discipline; and (III) to maintain investor confidence.” Dodd–Frank Act § 112(a)(2)(N), 12 U.S.C. § 5322 (2012).

²⁹⁶ Criddle, *supra* note 292, at 483–84.

a mandate that makes it clear that the ultimate purpose of financial stability regulation is to protect the broader economy, the courts (particularly the D.C. Circuit) may treat the financial system as an end in itself, and assess the FSOC's actions from a more efficiency-oriented perspective that focuses on the costs that financial stability regulation imposes on the financial industry.²⁹⁷ It is very difficult for financial stability regulation to survive an "arbitrary and capricious" review that is based on notions of efficiency and assessed by virtue of quantified cost-benefit analysis,²⁹⁸ and so the absence of a fulsome financial stability mandate gives opponents of financial stability regulation an upper hand in such litigation. Importantly, even the fear of such aggressive judicial review can be counterproductive in the context of financial stability regulation, to the extent that it encourages the FSOC to make timid recommendations that are less likely to be overturned by the courts, but more likely to unnecessarily complicate the financial system.²⁹⁹

Finally, there are practical difficulties that could result from Dodd-Frank's lack of clarity regarding "financial stability" and the FSOC's mandate. For example, Dodd-Frank tethered together different permutations and combinations of financial regulatory agencies by requiring them to make joint rulemakings, and to coordinate on the supervision and enforcement of those rules.³⁰⁰ This type of agency coordination is made more difficult if the agencies have different understandings of what the legislation is trying to achieve. In addition, the FSOC's currently articulated approach to financial stability—which emphasizes the ability of the financial system to absorb shocks as well as the absence of crisis—is inconsistent with the *ad hoc* approach recently articulated by the OFR, which uses the more limited "absence of crisis" conception of stability.³⁰¹ Given that the OFR provides the FSOC with data regarding financial stability issues, it is easy to see that inconsistent informal approaches could cause problems with regard to the

²⁹⁷ See Allen, *supra* note 31, at 176–77.

²⁹⁸ See *supra* text accompanying notes 144–49. For a discussion of how the professionalism and expertise of administrative agencies makes them worthy of, and legitimizes, deference, see Sidney Shapiro et al., *The Enlightenment of Administrative Law: Looking Inside the Agency for Legitimacy*, 47 WAKE FOREST L. REV. 463, 486–91 (2012).

²⁹⁹ C. F. LARRY HEIMANN, ACCEPTABLE RISKS: POLITICS, POLICY, AND RISKY TECHNOLOGIES 18 (1998); Allen, *supra* note 31, at 186–87.

³⁰⁰ Some notable examples include the multi-agency rulemaking made pursuant to section 619 of Dodd-Frank (the so-called "Volcker Rule"), and definitional rules relating to swaps made jointly by the SEC and CFTC pursuant to sections 112(a)(8), (d)(1), and 712(d)(2)(B), (C) of Dodd-Frank.

³⁰¹ The OFR has described financial stability as: "The condition in which the financial system is sufficiently functioning to provide its basic tasks for the economy even under stress." OFFICE OF FIN. RESEARCH, 2012 ANNUAL REPORT 133 (2012), <http://financialresearch.gov/annual-reports/files/office-of-financial-research-annual-report-2012.pdf> [<http://perma.cc/QG2K-BQ2W>].

overall assessment of risks to financial stability.³⁰² A more fulsome legislative description of “financial stability” would generate more clarity and consistency in financial stability regulation.

V. SOME SUGGESTIONS FOR REFORM

The previous Part identified a number of features of the FSOC and its mandate that are likely to impair the FSOC’s ability to promote financial stability. Given the importance of financial stability to society, this Part will consider potential reforms to improve the efficacy of financial stability regulation. While the political economy of financial stability regulation will remain (at least to some extent) a perennial problem, “buffers can be put in place to reduce unwarranted political pressure that can harm the public interest.”³⁰³ To this end, Part V.A argues for the abandonment of the FSOC and the creation of a stand-alone prudential regulator, with a sizable staff and budget, to address financial stability. This would be the “Cadillac” reform option, but there is clearly no political support for this type of radical reform at present. Part V.A. is thus best thought of as a thought experiment, which might inform reform efforts after the next crisis. Part V.B, on the other hand, explores a number of reforms that work within the existing U.S. financial regulatory framework. Again, it is unlikely that there is sufficient political will to implement any of these at present, but these proposals stand a stronger chance of being implemented as responses to future crises.

A. A Stand-Alone Prudential Regulator

The United States’ bewildering array of financial regulatory agencies is more a product of accident than of any conscious design.³⁰⁴ Although some have argued that the existing fragmented architecture has some benefits (in terms of creating competition amongst regulators, resulting in more specialized and efficient regulatory agencies),³⁰⁵ the predominant consensus is that the current structure makes little sense.³⁰⁶ As Part IV.A.iii explored, numerous coordination problems arise as a result of the division of financial stability regulation functions amongst these different regulatory agencies.

³⁰² Dodd–Frank Act § 153(a)(1), 12 U.S.C. § 5343 (2012).

³⁰³ Barkow, *supra* note 243, at 79.

³⁰⁴ “The current regulatory structure for financial institutions in the United States developed in a piecemeal fashion over time, often in response to various financial and economic conditions existing in the past.” THE DEP’T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 143 (Mar. 2008) [hereinafter BUSH BLUEPRINT], <http://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf> [<http://perma.cc/BQY7-T7HA>].

³⁰⁵ CARNELL ET AL., *supra* note 77, at 65.

³⁰⁶ *Id.* at 63–64; John C. Coffee, Jr., *Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation*, 50 BUS. LAW. 447, 481–82 (1995).

However, in the wake of the Financial Crisis, there was no real attempt to consolidate responsibility for financial stability issues into a single regulatory body.³⁰⁷ Thus, for context regarding how a consolidated financial regulator might address financial stability issues, we need to look abroad. This Part will consider both the British and the Australian experiences with consolidated financial regulators, and the lessons they suggest for regulatory reform in the United States.

The Financial Services and Markets Act of 2000 consolidated supervision of the entire British financial industry in the Financial Services Authority (the FSA).³⁰⁸ As such, the FSA had responsibility for prudential stability concerns as well as for market conduct issues. Although consolidating all financial regulators into one might seem superficially appealing,³⁰⁹ in retrospect, it is clear that financial stability concerns were largely trumped by other regulatory objectives in the pre-Crisis FSA.³¹⁰ The Turner Review, released in the wake of the Financial Crisis, indicated that the FSA favored efficiency over stability as a regulatory philosophy, and that that preference manifested itself in a *laissez-faire*, market discipline-based approach that often eschewed the interventionist regulation necessary as a prudential supervisor.³¹¹ There is a risk, then, that if the U.S. were to create a single financial regulator, “one type of regulation would come to dominate within [that] single regulator”³¹² and given that financial stability regulation fails to attract public attention in boom times, it is the type of regulation most likely to fall by the wayside.³¹³ As Senator Collins pointed out in the debates regarding Dodd–Frank, “the experience in the United Kingdom demonstrates, [the consolidation of regulatory agencies into one] would be no guarantee that our Nation’s economy would be shielded from systemic risk.”³¹⁴ The United Kingdom’s experience with the FSA cautions against the creation of a monolithic financial regulator in the United States; in fact, the FSA’s track record was so poor that

³⁰⁷ Although the Bush Blueprint indicated that the twin peaks approach was the optimal one, it was never pursued. BUSH BLUEPRINT, *supra* note 304, at 143. Obama’s original proposal instead fixed on the notion of creating a council of regulators to deal with systemic risk. OBAMA WHITE PAPER, *supra* note 4, at 3. Susan Collins, a Republican who supported financial reform, agreed that a council of regulators was the best approach: “To my mind, the President’s decision to rely on a council model makes his proposal far more practical and effective than alternatives which would have required the restructuring of most or all of the financial agencies that currently oversee the financial system.” 111 CONG. REC. S6,682 (daily ed. June 17, 2009) (statement of Sen. Collins) [hereinafter Collins Statement].

³⁰⁸ Financial Services and Markets Act 2000, c. 8, §§ 1–2 (UK).

³⁰⁹ For a discussion of the arguments advanced in support of the creation of the FSA (including efficiency and economies of scale), see Taylor, *supra* note 80, at 73–78.

³¹⁰ THE TURNER REVIEW, *supra* note 136, at 87.

³¹¹ *Id.*

³¹² Taylor, *supra* note 80, at 82.

³¹³ *Id.* at 81.

³¹⁴ Collins Statement, *supra* note 307, at S6,682.

it was entirely restructured by the United Kingdom's Financial Services Act of 2012.³¹⁵

Instead, many have concluded that the so-called "twin peaks" model is best calculated to ensure a regulatory focus on financial stability issues.³¹⁶ The twin peaks model involves the creation of two distinct regulatory bodies: one with responsibility for prudential regulation of *all* financial institutions, and the other with responsibility for market conduct regulation (in each case, without regard for the legal form of the financial institutions being regulated, thus limiting the potential for regulatory arbitrage).³¹⁷ Because the prudential regulatory body is not distracted by any primary responsibility for efficiency or other market conduct issues, it is structured in a way that maximizes the likelihood that it will maintain a long-term focus on financial stability.³¹⁸ Furthermore, a prudential agency that regulates a broad range of activities and firms (rather than splitting jurisdiction along the lines of banking, securities, derivatives, and insurance—as is currently the case in the United States) might be less susceptible to capture, because it is less beholden to the worldview of any one segment of the financial industry.³¹⁹

A form of the twin peaks model was implemented in the United Kingdom in 2013, when two bodies (the Prudential Regulatory Authority and the Financial Conduct Authority) replaced the FSA.³²⁰ These agencies are too new to offer much guidance to the United States at present. However, the twin peaks model has a much longer history in Australia, which adopted the model in 1998 with the creation of the Australian Prudential Regulation Authority (APRA)³²¹ and the restructuring of the Australian Securities & Investments

³¹⁵ Financial Services Act 2012, c. 21, § 6 (UK).

³¹⁶ The Bush Blueprint concluded that "The optimal objectives-based regulatory structure . . . somewhat resembles the model adopted in Australia." BUSH BLUEPRINT, *supra* note 304, at 143. In addition, a report by the Group of 30 noted that: "There is a growing interest in and support for 'regulation by objective' of the Twin Peaks Approach to supervision." GROUP OF THIRTY, THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE 14 (2008) [hereinafter G30 REPORT], <http://www.group30.org/images/PDF/The%20Structure%20of%20Financial%20Supervision.pdf> [<http://perma.cc/CW8C-CCVR>].

³¹⁷ Taylor, *supra* note 80, at 78.

³¹⁸ *Id.* at 81.

³¹⁹ Barkow, *supra* note 243, at 50; Elizabeth F. Brown, *A Comparison of the Handling of the Financial Crisis in the United States, the United Kingdom and Australia*, 55 VILL. L. REV. 509, 563 (2010).

³²⁰ Financial Services Act 2012, c. 21, §§ 2, 6 (UK).

³²¹ "[APRA] is the prudential regulator of the Australian financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, private health insurance, friendly societies, and most of the superannuation industry. . . . It was established on 1 July 1998." *About APRA*, AUSTL. PRUDENTIAL REG. AUTHORITY, <http://apra.gov.au/AboutAPRA/Pages/Default.aspx> [<http://perma.cc/7MUU-92DJ>].

Commission (ASIC).³²² APRA has had a good track record with regard to financial stability since that time: no Australian banks suffered losses, nor did Australia drop into recession, as a result of the Financial Crisis.³²³ Of course, there were other mitigating factors that help explain why Australia emerged from the Financial Crisis relatively unscathed,³²⁴ and it is impossible to disentangle the impact of Australia's regulatory structure from these other mitigating factors. Nonetheless, there are a number of APRA's features that seem calculated to produce an agency conducive to financial stability regulation. The remainder of this Part will explore how these features could be replicated (and supplemented) in the United States to create a stand-alone prudential regulatory agency that is most likely to take the proactive, long-term regulatory approach so necessary to financial stability regulation.

To implement the twin peaks approach in the United States, the FSOC, OCC, FDIC, SEC, CFTC, CFPB, and NCUA would all be abolished. In their place would be created two new agencies—a market conduct and consumer protection regulator (similar to Australia's ASIC), and a stand-alone prudential regulator (similar to Australia's APRA). This Article is concerned primarily with financial stability and thus focuses only on the design of the latter agency, which would be a federal agency with prudential authority over all institutions carrying out financial activities (including insurance activities), no matter what the form of the legal entity carrying out those activities.³²⁵

Implementing the twin peaks model in the United States should also entail denuding the Federal Reserve of its function as a bank supervisor and of its authority under Dodd–Frank to supervise SIFIs³²⁶ (the Australian central bank—the Reserve Bank of Australia (RBA)—does not actively supervise financial institutions).³²⁷ This would diminish Federal Reserve dominance in financial stability matters, potentially making regulation in the United States less bank-centric. The Federal Reserve would remain responsible for monetary policy, and would also retain its lender-of-last-resort function,³²⁸ but it would fulfill such functions with information provided by the newly created

³²²“In 1998 the organisation took on responsibility for consumer protection in superannuation, insurance and deposit taking and was renamed the Australian Securities and Investments Commission.” *How We Operate*, AUSTL. SEC. & INV. COMM'N, <http://asic.gov.au/about-asic/what-we-do/how-we-operate/> [<http://perma.cc/XU7Q-553N>] (last updated May 15, 2015).

³²³Brown, *supra* note 319, at 519, 521, 550.

³²⁴For a fulsome exploration of the many factors that influenced Australia's superior performance during the Financial Crisis, see Jennifer G. Hill, *Why Did Australia Fare So Well in the Global Financial Crisis?*, in *THE REGULATORY AFTERMATH OF THE GLOBAL FINANCIAL CRISIS* 203, 244 n.300 (Eilís Ferran et al. eds., 2012).

³²⁵Such a restructuring could limit opportunities for institutional regulatory arbitrage, and the growth of the shadow banking industry.

³²⁶Dodd–Frank Act § 165, 12 U.S.C. § 5365 (2012).

³²⁷G30 REPORT, *supra* note 316, at 40.

³²⁸For a summary of the Federal Reserve's current functions, see CARNELL ET AL., *supra* note 77, at 61.

prudential regulator, rather than gathering such information itself in the course of its supervision. While there are many who argue strenuously that “the information acquired in the capacity of . . . supervisor [is] essential to the central bank performing the lender-of-last-resort function”³²⁹ given that systemic risks can arise all over the financial system (and not just within the banks and SIFIs that the Federal Reserve currently regulates),³³⁰ it is naïve to think that the Federal Reserve can gather all the information it needs to discharge its lender-of-last-resort functions through its own supervisory function. Instead, like the RBA in Australia, the Federal Reserve should rely on Memoranda of Understanding and close cooperation with the prudential regulatory agency (and others) to ensure that it has the necessary information to determine when it should exercise its lender-of-last-resort function.³³¹

Following the restructuring proposed in this Part, the Secretary of the Treasury would no longer have an official role within the agency dedicated to financial stability. This would alleviate the concerns previously raised about the Secretary of the Treasury politicizing financial stability regulation.³³² Furthermore, the OFR would be removed from the Treasury (where it currently resides) and relocated within the new stand-alone prudential agency. In such context, the OFR may be able to achieve its promise as a “regulatory contrarian.”³³³ Insulated from the more politicized Treasury, it would presumably have more freedom to raise unpopular arguments and issues in a way that disrupts groupthink about where systemic risks lie.³³⁴ In addition, Barkow has noted that the ability of an agency to generate and disseminate information is key to retaining public support.³³⁵ an effective OFR could release information in a way that assists in maintaining a positive public profile for financial stability regulation and the new prudential agency.

In terms of structuring the new prudential agency itself, there are a number of APRA’s features that should be emulated. For example, APRA’s members are appointed by the executive rather than being elected officials³³⁶ and can only be terminated for certain specified causes.³³⁷ To ensure the independence of a stand-alone United States prudential regulator, these features should be

³²⁹ Taylor, *supra* note 80, at 84; *see also* G30 REPORT, *supra* note 316, at 40.

³³⁰ *See supra* text accompanying notes 75–80. Regarding the potential for smaller financial institutions to destabilize the financial system, *see* Stiglitz, *supra* note 97, at 17.

³³¹ There is a Memorandum of Understanding between APRA and the RBA regarding cooperation and coordination in instances involving threats to the financial system’s stability. G30 REPORT, *supra* note 316, at 195.

³³² *See supra* Part IV.A.2.

³³³ McDonnell & Schwarcz, *supra* note 91, at 1670.

³³⁴ *Id.* at 1647–48.

³³⁵ Barkow, *supra* note 243, at 59.

³³⁶ *See* Gadinis, *supra* note 176, at 336. The members of APRA are appointed by the Australian Governor-General, on the recommendation of the Treasurer. G30 REPORT, *supra* note 316, at 191.

³³⁷ Australian Prudential Regulatory Authority Act 1998 s 25(2) (Austl.).

replicated.³³⁸ This would ensure that the stand-alone regulator would be more apolitical than the current FSOC, which is rendered susceptible to the vagaries of political economy by the prominence of the Secretary of the Treasury within the council.³³⁹ Such an approach should not be considered unusual or controversial; at present, the heads of most of the existing financial regulatory agencies in the United States are appointed, and can only be removed for cause.³⁴⁰ What *is* likely to be controversial is whether the new agency should be headed by a single director or a multi-member commission; this was a matter of heated debate in the context of the founding of the CFPB.³⁴¹ There are, of course, benefits and drawbacks to both approaches. Multi-member commissions can be viewed as promoting collegiality and deal making, or decried as promoting inaction and wasteful horse-trading.³⁴² While a single director is more likely to be efficient and accountable than a group of commissioners, he or she brings only one perspective to the position, and is also potentially more susceptible to capture.³⁴³

On balance, this Article recommends following APRA,³⁴⁴ and implementing a multi-member commission for the new agency.³⁴⁵ One of the

³³⁸ In the United States, “the defining hallmark of an independent agency is that it is headed by someone who cannot be removed at will by the President but instead can be removed only for good cause.” Barkow, *supra* note 243, at 16.

³³⁹ See *supra* Part IV.A.2.

³⁴⁰ Barkow, *supra* note 243, at 29.

³⁴¹ See, e.g., Ben Protess, *Warren and Republicans Spar Over Bureau’s Power*, N.Y. TIMES: DEALBOOK (May 24, 2011, 3:11 PM), http://dealbook.nytimes.com/2011/05/24/warren-and-g-o-p-lawmakers-spar-over-bureaus-power/?_r=1 [<http://perma.cc/VV5X-H9F6>].

³⁴² Levitin Testimony, *supra* note 264, at 9–10.

³⁴³ Barkow, *supra* note 243, at 37–38.

³⁴⁴ APRA is headed by no more than five and no less than three members. Australian Prudential Regulatory Authority Act 1998 s 16(1) (Austl.).

³⁴⁵ Instituting a diversified multi-member commission seems important from a legitimacy perspective: given the sweeping powers that the new agency would wield, it would be unwise to concentrate that power in the hands of one person or one party (also, one person or party is more easily captured by industry than a diversified multi-member commission). While it has been argued that single directors have more of a bias towards action than do multi-member commissions, Levitin Testimony, *supra* note 264, at 10, that would seemingly depend on the ideology of the director in question. A single director that is opposed to action is likely to be more passive than a multi-member commission. A multi-member commission *is* less likely to be efficient than an agency with a single director, *id.* at 9–10, but given that this Article’s proposal would result in a reduction of the number of federal financial regulatory agencies from eight to two, even with a multi-member commission, it is still a net positive from an efficiency perspective (a move to a single agency would also cut down on wasteful turf battles between existing financial regulatory agencies). The biggest concern in terms of instituting a multi-member commission to govern the new prudential regulatory agency is the risk of shirking—it is harder to hold multi-member commissions accountable than single directors. *Id.* However, this trade-off seems worthwhile given that a multi-member commission best allows for the broad range of perspectives necessary for effective financial stability regulation. Barkow,

key arguments of this Article is that, when dealing with financial stability, regulatory imagination and a broad-view perspective are vital. These are more likely to be achieved with multiple commissioners with heterogeneous perspectives than with a single director.³⁴⁶ Ideally, the new agency would be structured so that each commissioner would represent a different area of expertise: one member could be drawn from a pool of qualified persons with banking expertise, another could be drawn from a pool with securities expertise, another would have insurance expertise, another derivatives expertise, and another experience with funds. There should also be sufficient flexibility to include new areas of financial expertise as they evolve. The commissioners should be somewhat balanced in terms of political party affiliations, as research indicates that “a group composed solely of ideologically like-minded people tends toward extreme decision making.”³⁴⁷ Each of the commissioners should be required to testify before Congress on a regular basis, so that no one commissioner dominates the new agency’s messaging, and in a similar vein, it would be helpful if the role of chairing the commission and setting its agenda could rotate amongst the commissioners. If the new agency were structured such that each year, a commissioner with a different type of expertise would set the agency’s priorities, then that would maximize the chance of different perspectives being heard in the long run.

Typically, multi-member commissions of independent agencies are appointed with “the advice and consent of the Senate.”³⁴⁸ Thought should thus be given as to which Senate committee would oversee the appointment process, and indeed which committee should oversee the new agency in general. Given the desire to break the bank-centric mentality that currently informs financial stability regulation, it would be best if the new agency did not operate under the aegis of the Senate Banking Committee. Instead, a committee with a broader purview, such as the Finance Committee, should oversee the new prudential regulatory agency. Preferably, a public-minded subcommittee on financial stability would be established within the Finance Committee for the purpose of overseeing financial stability and the new agency, so that the agency’s political overseers are less likely to focus solely on appeasing financial industry interests.³⁴⁹

supra note 243, at 37–38. For further discussion of these issues, see *id.* at 37–38, 53; Levitin Testimony, *supra* note 264, at 10–11.

³⁴⁶ Marisam notes that groupthink can be disrupted by “staff and officials with significantly different professional backgrounds and regulatory experiences.” Marisam, *supra* note 259, at 214. Barkow notes that a single director “means less deliberation and debate.” Barkow, *supra* note 243, at 37.

³⁴⁷ Barkow, *supra* note 243, at 40.

³⁴⁸ U.S. CONST. art. II, § 2, cl. 2.

³⁴⁹ For a discussion of the importance of locating an agency “within the jurisdiction of an oversight committee that is more likely to favor a broad public interest than industry interests,” see Barkow, *supra* note 243, at 62.

The leadership structure of the new agency is important, but the new agency's method of funding will also be key to ensuring its focus on the public interest. The new agency would require a robust staff (including the OFR) to discharge its functions, and reliance on either the President or Congress for funding to support that staff would compromise the independence of the prudential regulator.³⁵⁰ Instead, funding should be levied from industry fees (APRA is similarly funded).³⁵¹ Admittedly, past experience has shown that reliance on industry fees made regulators like the OCC and the OTS more susceptible to industry capture.³⁵² However, the OCC and OTS were competing to implement ever-laxer regulation in order to attract institutions to charter with them (and thus expand their influence and funding pools)—resulting in pervasive capture and a deregulatory “race to the bottom.”³⁵³ If a new prudential regulatory agency were created, financial institutions would have no choice as to whether they would be regulated by it, and so there would be no competition for the industry's favor in order to attract funding. Independence from elected officials could thus be bolstered without increasing dependence on the financial industry.

Finally, the statutory mandate of the new agency is also important. APRA is directed “to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.”³⁵⁴ While this mandate does include a statutory direction to consider efficiency concerns, APRA is directed to prioritize financial stability concerns. Granting the United States prudential regulator a similar paramount financial stability mandate can assist in training regulatory focus on financial stability (even in normal and boom times), and in fostering a public-focused regulatory identity. As Kwak has noted, “[s]omeone who identifies as an economically sophisticated steward of efficient financial markets will adopt different policy positions from someone who identifies as a defender of the ‘little guy.’”³⁵⁵ A statutory charge to protect the public from the fallout from financial instability would thus frame the agency's decision-making in a different light. The example of the Environmental Protection Agency (EPA) is instructive here³⁵⁶: the EPA is often cited as an administrative agency that identifies primarily with the

³⁵⁰ *Id.* at 44.

³⁵¹ “APRA is largely financed by fees imposed on the financial sector entities it supervises as determined and collected by the Australian government—as a levy on supervised entities.” G30 REPORT, *supra* note 316, at 193.

³⁵² Barkow, *supra* note 243, at 44–45 n.159.

³⁵³ Wilmarth, *supra* note 294, at 1390–92.

³⁵⁴ Australian Prudential Regulatory Authority Act 1998 s 8(2) (Austl.).

³⁵⁵ See Kwak, *supra* note 85, at 83.

³⁵⁶ “The mission of [the] EPA is to protect human health and the environment.” *About EPA: Our Mission and What We Do*, U.S. ENVTL. PROTECTION AGENCY, <http://www2.epa.gov/aboutepa/our-mission-and-what-we-do> [<http://perma.cc/9SVK-QXKD>].

interests of the public,³⁵⁷ and is thus less susceptible to cognitive capture by its regulated industries on issues like clean air regulation.³⁵⁸ In a similar vein, Wilmarth has argued that, when compared with other banking regulators, the FDIC has exhibited fewer signs of capture,³⁵⁹ partially because of the FDIC's "clearly defined mission" as the protector of the little guys (depositors) and of a public good (the Deposit Insurance Fund).³⁶⁰

Of course, if we assume that regulators are motivated entirely by self-interest, then a financial stability mandate would make little difference to how regulators carry out their jobs, (at least in normal times, when the costs of financial instability are not particularly salient to the public at large, and there is thus little reputational cost to abandoning stability efforts).³⁶¹ Purely self-interested regulators, for example, might purposefully defer to industry interests in drafting and enforcing regulations in order to avoid conflict with the industry (i.e., prefer their own self-interest in an "easy life"), or to procure an industry job in the future.³⁶² However, we should be careful about how much credence is given to this assumption about self-interest. There is empirical research that indicates that regulatory agencies will often actively prefer the longer term public interest to their own short-term self-interest.³⁶³ To the extent that regulators genuinely identify with the benefits of long-term financial stability, taking actions that instead prioritize the short-term

³⁵⁷ Kwak, *supra* note 85, at 84–85.

³⁵⁸ For a discussion of the EPA's decision to tighten restrictions on ozone and particulate matter in the face of extremely strong industry opposition, see Steven P. Croley, *Public Interested Regulation*, 28 FLA. ST. U. L. REV. 7, 55–66 (2000).

³⁵⁹ Arthur E. Wilmarth, Jr. wrote:

During the period leading up to the financial crisis, the FDIC (i) generally took a tougher position against subprime mortgage lending, and (ii) "fought hard to maintain tougher capital rules for U.S. banks (including leverage capital requirements) during international negotiations over the Basel II capital accord." The FDIC also pushed the Basel Committee on Bank Supervision to adopt stronger capital standards—including a leverage requirement—in the post-crisis Basel III accord, although Basel III did not go far enough. The FDIC prevailed (over the opposition of New York Fed and Treasury officials) in deciding that WaMu's bondholders would *not* be bailed out when WaMu failed in September 2008. The FDIC achieved partial success—again despite the contrary views of Fed and OCC officials—when it pressured the largest banks to satisfy tougher capital-raising requirements in order to exit the TARP capital assistance program.

Wilmarth, *supra* note 294, at 1405 (footnotes omitted) (quoting Arthur E. Wilmarth, Jr., *The Financial Services Industry's Misguided Quest to Undermine the Consumer Financial Protection Bureau*, 31 REV. BANKING & FINANCIAL L. 881, 947–48 (2012)).

³⁶⁰ *Id.* at 1404.

³⁶¹ Anabtawi & Schwarcz, *supra* note 72, at 97 n.174; Short, *supra* note 83, at 652.

³⁶² Omarova, *supra* note 291, at 630.

³⁶³ See Bradley, *supra* note 166, at 778.

profitability of the financial industry will cause them troubling cognitive dissonance.³⁶⁴

Overall, then, there is much to be gained from creating a stand-alone prudential regulatory agency in the United States. The mere act of shaking up the existing financial regulatory structure, where many of the agencies have demonstrated a strong culture of capture,³⁶⁵ could have salutary effects. However, the United States has proven consistently stubborn about rationalizing its financial regulatory architecture.³⁶⁶ Recognizing that such rationalization may be a bridge too far, the next section will therefore consider the possibility of leaving the United States' existing financial regulatory structure largely intact, but making changes (some limited, some more drastic) to improve regulatory focus on financial stability.

B. Working Within the Existing Regulatory Framework

There are a number of changes to Dodd–Frank that would help legitimize and increase the salience of the FSOC's efforts to promote financial stability. For example, section 112(a)(1)(B) would ideally be repealed, allowing the FSOC to work on formalizing, in advance, *ex post* safety nets designed to mitigate future crises. Most importantly, though, financial stability should be defined, in order to authorize the exercise of regulatory discretion in a way that prioritizes the interests of society as a whole in financial stability. To this end, Dodd–Frank should be amended to include something akin to the following definition of financial stability:

The term “financial stability” shall mean a state of affairs wherein (i) financial institutions and markets are able to facilitate capital intermediation, risk management, and payment services in a way that enables sustainable economic growth; (ii) there is no disruption to the ability of financial institutions or markets to carry out such functions that might cause harm to persons (wherever they may be resident) who are not customers or counterparties of those financial institutions, nor participants in those financial markets; and (iii) financial institutions and markets are able to withstand economic shocks (such as the failure of other markets and institutions, or a chain of significant losses at financial institutions) so that (x) there will be no disruption to the performance of the functions set forth in (i) and (y) no harm will be caused to the persons set forth in (ii).³⁶⁷

Admittedly, a mandate to pursue financial stability, defined as per this Part, would not be overly prescriptive. This may be dissatisfying for some, who might seek more precise direction for the FSOC as to how to proceed in

³⁶⁴ Kwak, *supra* note 85, at 94.

³⁶⁵ Barkow, *supra* note 243, at 75.

³⁶⁶ Coffee, *supra* note 306, at 447–48; *see also* CARNELL ET AL., *supra* note 77, at 64.

³⁶⁷ Allen, *supra* note 53, at 932.

achieving financial stability³⁶⁸—perhaps by using a quantitative metric that indicates precisely when the financial system is and is not stable, and when intervention is and is not required. However, there are perils inherent in hewing too closely to mandates that are simple to follow, but do not accurately reflect the real risks inherent in the financial system.³⁶⁹ In reality, a need for regulatory discretion is inevitable when dealing with complex subject matter.³⁷⁰ This Part’s proposed definition of financial stability seeks to strike a balance such that the financial stability mandate is “neither excessively self-confident about what we know about financial stability so as to produce unfortunate unintended consequences, nor excessively tentative so as to fail to take steps to counter the very real risks that do exist.”³⁷¹

Turning from the FSOC’s mandate to its structure, the key purpose of any structural reform should be to increase the participation, commitment and accountability of the FSOC’s voting members (particularly those other than the Federal Reserve and the Treasury) with respect to financial stability matters. There are a number of incremental reforms that could assist in focusing agencies on financial stability issues. For example, section 112(b) of Dodd–Frank currently requires the FSOC’s voting members to submit signed statements certifying their belief that the FSOC, the government, and the private sector “are taking all reasonable steps to ensure financial stability and to mitigate systemic risk that would negatively affect the economy.”³⁷² While on its face it might seem that this certification would hold the voting members accountable for financial stability issues, the phrasing of the certification is important—it does not require a voting member to certify that *their agency*, independently, is taking steps to promote financial stability. Pursuant to section 112(b), the voting member is merely stating his or her belief as to the actions of the FSOC, over which he or she has no controlling influence. Here, it would be beneficial to follow the lead of section 302 of the Sarbanes–Oxley Act³⁷³ and alter the certification such that it requires the voting member to take, at least symbolically, personal responsibility for their agency’s commitment to financial stability matters. The signed statement should be required to refer to satisfaction with the agency’s own efforts to promote

³⁶⁸ The *purported* precision of the efficiency mandate, as measured by cost–benefit analysis, is part of its appeal. See Allen, *supra* note 31, at 203.

³⁶⁹ For a discussion of the limiting potential of quantitative models, see Erik F. Gerding, *Code, Crash and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis*, 84 WASH. L. REV. 127, 170–75 (2009).

³⁷⁰ In our complex society, “the brute fact [is] that the law necessarily entrusts policy-making discretion to administrative agencies.” Criddle, *supra* note 292, at 491.

³⁷¹ Tarullo, *supra* note 180, at 27.

³⁷² Dodd–Frank Act § 165, 12 U.S.C. § 5365 (2012).

³⁷³ Section 302 of Sarbanes–Oxley requires CEOs and CFOs to personally certify financial reports, in an attempt to “ensur[e] personal responsibility” for the acts of the corporation controlled by the CEO and CFO, at least at a symbolic level. Lisa M. Fairfax, *Form over Substance: Officer Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes–Oxley Act*, 55 RUTGERS L. REV. 1, 2–3 (2002).

financial stability, as well as the efforts of the FSOC, the government, and the private sector.

The Congressional hearing required by section 112(a)(2)(N) of Dodd–Frank could be adapted to a similar end.³⁷⁴ That section requires the Treasury Secretary, on behalf of the FSOC, to testify before Congress each year regarding “potential emerging threats to the financial stability of the United States.”³⁷⁵ This requirement could be expanded such that all of the FSOC’s voting members (and not just the Treasury Secretary) are required to appear together before Congress at this annual hearing, and field questions regarding financial stability. In doing so, the FSOC’s voting members would not only maintain the salience of financial stability issues for themselves, they would also play an educative role,³⁷⁶ informing the legislature and the public at large about risks arising in the non-bank corners of the financial system.

Thus far, this Part has discussed reforms that merely tinker around the edges of Dodd–Frank. While helpful, these are limited in their ability to address the key problem that arises when an express financial stability mandate is given to a council of regulatory agency leaders, but not to the agencies themselves: if the agencies are not concerned with financial stability issues, then a council of their leaders is unlikely to be effective in pursuing financial stability.³⁷⁷ A more radical approach would be to give *all* of the federal financial regulatory agencies express statutory mandates to pursue financial stability. The arguments for giving each federal financial agency a financial stability mandate largely echo arguments that have already been made in favor of a fulsome financial stability mandate for the FSOC, and for an APRA-style prudential regulator. For example, conferring a statutory financial stability mandate on each of the agencies (especially when coupled with a requirement to regularly testify before Congress as to how the agency is satisfying such mandate) could mitigate the political economy of financial stability regulation by training regulatory attention on financial stability issues even in normal and boom times, when the public is largely oblivious to such issues.³⁷⁸ The mandate could also permit the agencies to develop broader, simpler, rules that are better calculated to promote stability than rules that deal too granularly with the minutiae of financial activities—with less fear of rebuke from the D.C. Circuit.³⁷⁹ Finally, the mandate could be instrumental in

³⁷⁴ Dodd–Frank Act § 112(a)(2)(N).

³⁷⁵ *Id.*

³⁷⁶ Criddle, *supra* note 292, at 475. The dissemination of information that occurs as part of that testimony can “help energize the public to overcome collective action problems and rally behind the agency.” Barkow, *supra* note 243, at 59.

³⁷⁷ The GAO noted from interviews with individual financial agencies their position “that any effort to coordinate rulemakings assigned to specific agencies through FSOC would need to be balanced against the statutory requirements of the independent agencies involved.” Clowers Statement, *supra* note 161, at 5.

³⁷⁸ See *supra* text accompanying notes 354–60.

³⁷⁹ See *supra* text accompanying notes 295–99.

fostering public-focused regulatory identities, rendering financial regulators less susceptible to lobbying and cognitive capture.³⁸⁰

While the reforms discussed in this Part seek to work within the United States' existing regulatory framework, there are two structural reforms that would be required to make the FSOC a truly effective coordination mechanism. First, the Treasury Secretary should be removed from his or her position of prominence within the FSOC. Instead, the FSOC should be chaired by an independent, separately funded Chairperson who is appointed by the President, and can only be removed for cause.³⁸¹ (This was, in fact, the approach that Senator Collins favored at the time Dodd–Frank was being debated. She argued that the Treasury Secretary should not chair the FSOC, and that the independence of the FSOC should be preserved by appointing a Chairperson who would be unaffiliated with the Treasury, or any of the FSOC's member agencies)³⁸² Not only would such a reform reduce some of the political pressures on the FSOC, the new independent FSOC chairperson could also function as a type of regulatory contrarian.³⁸³ One criticism that has been leveled at the FSOC is that it will not address failures of imagination about financial stability and systemic risk “if the personnel in the [FSOC] are simply recycled regulators and central bankers.”³⁸⁴ However, if the Chairperson of the FSOC (together with his or her staff) were drawn from outside the traditional pool of financial regulators, they could bring new methodologies and philosophies to the task, which could help break regulatory groupthink about where the risks to financial stability lie.³⁸⁵

The second structural reform required is that insurance needs to be regulated at the federal level. Insurance has traditionally been regulated by the states, and although Dodd–Frank now requires the President to appoint to the FSOC an independent member with insurance expertise,³⁸⁶ and also

³⁸⁰ Jean-Charles Rochet, *Policies to Stabilize Financial Markets*, in FINANCIAL STABILITY AND MACROECONOMIC POLICY: A SYMPOSIUM SPONSORED BY THE FEDERAL RESERVE BANK OF KANSAS CITY 191, 192 (2009).

³⁸¹ The process for selecting and appointing this Chairperson could be modeled on the process currently used for selecting and appointing the independent member of the FSOC with insurance expertise. Dodd–Frank Act § 111(b)(1)(j), 12 U.S.C. § 5321 (2012).

³⁸² During the Dodd–Frank debate, Senator Susan Collins commented:

While I am pleased the President has chosen the council of regulators model as well, I differ with his proposal to have the Secretary of the Treasury serve as the head of the council. Instead, I believe the council's chairman should be independent of any of the regulatory agencies serving on the council and that it is important that that chairman devote his or her full energies to that role and not have other important responsibilities.

Collins Statement, *supra* note 307, at S6,682–683.

³⁸³ McDonnell & Schwarcz, *supra* note 91, at 1647–48.

³⁸⁴ Miller & Rosenfeld, *supra* note 203, at 838.

³⁸⁵ McDonnell & Schwarcz, *supra* note 91, at 1673.

³⁸⁶ Dodd–Frank Act § 111(b)(1)(j).

established a Federal Insurance Office (FIO) within the Treasury Department,³⁸⁷ state regulators still retain primacy in this area of the law.³⁸⁸ Unfortunately, state-level regulation is not particularly conducive to dealing with systemic risks and financial instability, given that the negative consequences of in-state activity are externalized throughout the country (and internationally).³⁸⁹ To ensure a focus on the systemic risks that the insurance industry can create, a federal regulator is needed,³⁹⁰ and a financial stability mandate should be conferred on such regulator.

The FSOC could be an extremely useful coordination and communication authority if it were working with a group of financial regulatory agencies that were truly committed to addressing threats to financial stability in all of their potentially different manifestations. Even if one or two member agencies were to attempt to shirk their newly-created statutory responsibilities for financial stability, the other member agencies—now charged with an express statutory obligation to address financial instability that they must fulfill or be held accountable for neglecting—would be more likely to exert the FSOC's power under section 120 of Dodd–Frank to bring the shirking agencies into line. Short of implementing such financial stability mandates, however, it is likely that most of the FSOC's members will abdicate responsibility for financial stability issues in normal and boom times, leaving (at most) only the Federal Reserve to monitor and address perceived threats to financial stability.

To be clear, this Part's proposal to give all federal regulators a financial stability mandate is inferior to the creation of an APRA-style prudential regulator. Each of the existing federal financial agencies has a pre-existing mandate over which the new financial stability mandate would be overlaid, and just as with the FSA in the UK, it may be that the pre-existing mandates will be prioritized over the new financial stability mandate.³⁹¹ Furthermore, the jurisdictions of the existing regulators tend to be delineated by industry, and focus on a particular type of industry makes the agency more susceptible

³⁸⁷ *Id.* § 502(a).

³⁸⁸ Daniel Schwarcz & Steven L. Schwarcz stated:

The FIO has no regulatory authority over the insurance industry[, and has only a very limited power to preempt state law when it determines those laws conflict with international legal agreements]. Instead, the FIO's principal role is to serve as a federal monitor of the insurance industry and state regulation and to “coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters.”

Schwarcz & Schwarcz, *supra* note 76, at 1590 (footnote omitted) (quoting Dodd–Frank Act § 313(c)(1)(E)).

³⁸⁹ *Id.* at 1627.

³⁹⁰ Schwarcz and Schwarcz have therefore argued that the FIO should be given expanded powers to regulate for systemic risk. *Id.* at 1634–39. Although the location of the FIO within the politicized Treasury is grounds for some concern, this Article generally supports the federalization of insurance regulation.

³⁹¹ See *supra* text accompanying notes 309–13.

to capture than a stand-alone regulator with sweeping jurisdiction would be.³⁹² Nonetheless, giving each financial regulator a statutory charge to monitor and address threats to financial stability is preferable to the status quo, where the federal financial regulatory agencies have (at best) implicit charges to consider financial stability issues.³⁹³

VI. CONCLUSION

Financial stability is a vital public good, and it is precisely when the economy is booming that the foundations for financial stability must be laid (for example, by restricting profitable but potentially destabilizing activities, or by formalizing *ex post* safety nets in anticipation of future instability, or by implementing restrictive countercyclical regulation in the face of warning signs of impending instability). However, the FSOC, as a body with limited resources and powers of its own, will be unable to aggressively pursue financial stability without the committed assistance of its member agencies. While the Federal Reserve does seem committed—at least at present—to pursuing financial stability, it is suboptimal for the Federal Reserve (informed as it is by its bank-centric perspective) to have a monopoly on financial stability regulation. Instead, the other financial regulatory agencies, which have information and expertise about disparate corners of the financial system, should also be actively involved in promoting financial stability. However, there is little incentive for them to do so, given that they have no express mandate or statutory instructions to pursue financial stability, and as the economy improves, any efforts to this end are likely to receive little public support—and harsh criticism from the financial industry. Unless the financial stability regulatory structure is altered to ensure that there is a substantive and independent regulatory body (or bodies) committed to, and accountable for, monitoring and addressing threats to financial stability, the United States will remain unnecessarily exposed to future financial crises—which will harm those outside of the financial system more than those within it.

³⁹² Barkow, *supra* note 243, at 50.

³⁹³ See *supra* Part IV.A.3.